APPENDIX A

Section 73 of Bankruptcy Act (11 USCA Sec. 201)

ADDITIONAL JURISDICTION

In addition to the jurisdiction exercised in voluntary and involuntary proceedings to adjudge persons bankrupt, courts of bankruptcy shall exercise original jurisdiction in proceedings for the relief of debtors, as provided in sections 202, 203, and 205 of this chapter.

Excerpts from Section 77 of Bankruptcy Act

(11 USCA Sec. 205)

REORGANIZATION OF RAILROADS ENGAGED IN INTERSTATE COMMERCE—PETITION FOR REORGANIZATION BY RAILROAD, SUBSIDIARY OR CREDITORS; VENUE; PROCEEDINGS THEREON; JURISDICTION OF COURT OVER DEBTOR AND PROPERTY . . . .

Plan of reorganization, contents; "securities", "stockholders", "creditors", "claims" defined; suspension of statutes of limitation.

(b) A plan of reorganization within the meaning of this section (1) shall include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character, or otherwise; (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan; (4) shall provide for fixed charges (including fixed interest on funded debt, interest on unfunded debt, amortization of discount on funded debt, and rent for leased railroads) in such amount that, after due

consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; (5) shall provide adequate means for the execution of the plan, which may include the transfer of any interest in or control of all or any part of the property of the debtor to another corporation or corporations, the merger or consolidation of the debtor with another corporation or corporations, the retention of all or any part of the property by the debtor, the sale of all or any part of the property of the debtor either subject to or free from any lien at not less than a fair upset price, the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein, the satisfaction or modification of any liens, indentures, or other similar interests, the curing or waiver of defaults, the extension of maturity dates of outstanding securities, the reduction in principal and/or rate of interest and alteration of other terms of such securities, the amendment of the charter of the debtor, and/or the issuance of securities of either the debtor or any such other corporation or corporations for cash, or in exchange for existing securities, or in satisfaction of claims or rights or for other appropriate purposes; and may deal with all or any part of the property of the debtor; may reject contracts of the debtor which are executory in whole or in part, including unexpired leases; and may include any other appropriate provisions not inconsistent with this section.

The adoption of an executory contract or unexpired lease by the trustee or trustees of a debtor shall not preclude a rejection of such contract or lease in a plan of reorganization approved hereunder, and any claim resulting from such rejection shall not have priority over any other claims against the debtor because such contract or lease had been previously adopted. The term "securities" shall include evidence of indebtedness either secured or unsecured, bonds, stock, certificates of beneficial interest therein, certificates of beneficial interest in property, options, and war-

rants to receive, or to subscribe for, securities. The term "stockholders" shall include the holders of voting-trust certificates. The term "creditors" shall include, for all purposes of this section all holders of claims of whatever character against the debtor or its property, whether or not such claims would otherwise constitute provable claims under this Act, including the holder of a claim under a contract executory in whole or in part including an unexpired lease.

The term "claims" includes debts, whether liquidated or unliquidated, securities (other than stock and option warrants to subscribe to stock), liens, or other interests of whatever character. For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors. In case an executory contract or unexpired lease of property shall be rejected, or shall not have been adopted by a trustee appointed under this section, or shall have been rejected by a receiver in equity in a proceeding pending prior to the institution of a proceeding under this section, or shall be rejected by any plan, any person injured by such nonadoption or rejection shall for all purposes of this section be deemed to be a creditor of the debtor to the extent of the actual damage or injury determined in accordance with principles obtaining in equity proceedings. The provisions of section 96 of this title shall apply to a proceeding under this section. For all purposes of this section any creditor or stockholder may act in person or by an attorney at law or by a duly authorized agent or committee subject to the provisions of subsection (p) of this section. The running of all statutes of limitation shall be suspended during the pendency of a proceeding under this section.

Proceedings after approval of petition.

(c) . . .

(2) . . .

The trustee or trustees so appointed, upon filing such bond, shall have all the title and shall exercise, subject to the control of the judge and consistently with the provisions of this section, all of the powers of a trustee appointed pursuant to section 72 or any other section of this title, and, to the extent not inconsistent with this section, if authorized by the judge, the powers of a receiver in an equity proceeding, and, subject to the control of the judge and the jurisdiction of the Commission as provided by chapter 1 of Title 49 as on August 27, 1935, or thereafter amended, the power to operate the business of the debtor. Prior to the appointment of a trustee, the debtor on behalf of the court shall continue in the possession of the property and shall operate the business thereof during such period, and shall have all the title to the property and shall exercise all power consistent with the provisions of this section subject at all times to the control of the judge, and to such limitations, restrictions, terms, and conditions as he may from time to time impose and prescribe . . . .

(10) The judge may direct the debtor or the trustee or trustees to keep such records and accounts, in addition to the accounts prescribed by the Commission, as will permit of such a segregation and allocation, as the necessities of the case may require, of the earnings and expenses between and to the divisions and parts of the railroad or other property of the debtor which are separately subject to the liens of the various mortgages or deeds of trust, or are separately subject to lease, and may refer to the Commission for its recommendations after hearings thereon if the parties shall so request and/or the Commission determine necessary or desirable, as to the method or formula by which such segregation and allocation shall be made; and thereafter such segregation and allocation may be made at the expense of the debtor's estate. . . .

Court hearing after approval by Commission; acceptance of plan by creditors and stockholders; confirmation of plan by court; valuation of property.

(e) Upon the certification of a plan by the Commission to the court, the court shall give due notice to all parties in interest of the time within which such parties may file with the court their objections to such plan, and such parties shall file, within such time as may be fixed in said notice, detailed and specific objections in writing to the plan and their claims for equitable treatment. The judge shall, after notice in such manner as he may determine to the debtor, its trustee or trustees, stockholders, creditors, and the Commission, hear all parties in interest in support of, and in opposition to, such objections to the plan and such claims for equitable treatment. After such hearing, and without any hearing if no objections are filed, the judge shall approve the plan if satisfied that: (1) it complies with the provision of subsection (b) of this section, if fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; (2) the approximate amounts to be paid by the debtor, or by any corporation or corporations acquiring the debtor's assets, for expenses and fees incident to the reorganization, have been fully disclosed so far as they can be ascertained at the date of such hearing, are reasonable, are within such maximum limits as are fixed by the Commission, and are within such maximum limits to be subject to the approval of the judge; (3) the plan provides for the payment of all costs of administration and all other allowances made or to be made by the judge, except that allowances provided for in subsection (c), paragraph (12) of this section, may be paid in securities provided for in the plan if those entitled thereto will accept such payment, and the judge is hereby given power to approve the same.

If the judge shall not approve the plan, he shall file an

opinion, stating his conclusions and the reason therefor, and he shall enter an order in which he may either dismiss the proceedings, or in his discretion and on motion of any party in interest refer the proceedings back to the Commission for further action, in which event he shall transmit to the Commission a copy of any evidence received. If the proceedings are referred back to the Commission, it shall proceed to a reconsideration of the proceedings under the provisions of subsection (d) of this section. If the judge shall approve the plan, he shall file an opinion, stating his conclusions and the reasons therefor, and enter an order to that effect, and shall send a certified copy of such opinion and order to the Commission. The plan shall then be submitted by the Commission to the creditors of each class whose claims have been filed and allowed in accordance with the requirements of subsection (c) of this section, and to the stockholders of each class, and/or to the committees or other representatives thereof, for acceptance or rejection, within such time as the Commission shall specify, together with the report or reports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge: *Provided*, That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, (a) that at the time of the finding the corporation is insolvent, or that at the time of the finding the equity of such class of stockholders has no value, or that the plan provides for the payment in cash to such class of stockholders of an amount not less than the value of their equity, if any, or (b) that the interests of such class of stockholders will not be adversely and materially affected by the plan, or (c) that the debtor has pursuant to authorized corporate action accepted the plan and its stockholders are bound by such acceptance: *Provided further*, That submission to any class of creditors shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding that the interests of such class of creditors will be adversely and materially affected by the plan, or that at the time of the find-

ing the interests of such class of creditors have no value, or that the plan provides for the payment in cash to such class of creditors of an amount not less than the value of their interests. For the purpose of this section the acceptance or rejection by any creditor or stockholder shall be in writing, executed by him or by his duly authorized attorney, committee, or representative. If the United States of America, or any agency thereof, or any corporation (other than the Reconstruction Finance Corporation) the majority of the stock of which is owned by the United States of America, is a creditor or stockholder, the interests or claims thereof shall be deemed to be affected by the plan, and the President of the United States, or any officer or agency he may designate, is hereby authorized to act in respect of the interests or claims of the United States or of such agency or other corporation. The expense of such submission shall be certified by the Commission and shall be borne by the debtor's estate. The Commission shall certify to the judge the results of such submission.

Upon receipt of such certification, the judge shall confirm the plan if satified that it has been accepted by or on behalf of creditors of each class to which submission is required under this subsection holding more than two-thirds in amount of the total of the allowed claims of such class which have been reported in said submission as voting on said plan, and by or on behalf of the stockholders of each class to which submission is required under this subsection holding more than two-thirds of the stock of such class which has been reported in said submission as voting on said plan; and that such acceptances have not been made or procured by any means forbidden by law: . . . .

If the judge shall confirm the plan, he shall enter an order and file an opinion with a statement of his conclusions and his reasons therefor. If the judge shall not confirm the plan, he shall file an opinion, with a statement of his conclusions and his reasons therefor, and enter an order in which he shall either dismiss the proceedings, or, in his discretion and on the motion of any party in interest, refer the case back to the Commission for further

proceedings, including the consideration of modifications of the plan or the proposal of new plans. In the event of such a reference back to the Commission, the proceedings with respect to any modified or new plan shall be governed by the provisions of this section in like manner as in an original proceeding hereunder.

If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan. The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts.

Binding effect of confirmation; discharge of debtor from liabilities; issuance of securities.

(f) Upon confirmation by the judge, the provisions of the plan and of the order of confirmation shall, subject to the right of judicial review, be binding upon the debtor, all stockholders thereof, including those who have not, as well as those who have, accepted it, and all creditors secured or unsecured, whether or not adversely affected by the plan, and whether or not their claims shall have been filed, and if filed, whether or not approved, including creditors who have not, as well as those who have accepted it. Upon confirmation of the plan, the debtor and any other corporation or corporations organized or to be organized for the purpose of carrying out the plan, shall have full power and authority to, and shall put into effect and carry out the plan and the orders of the judge relative thereto, under and subject to the supervision and the control of the judge, the laws of any State or the decision or order of

any State authority to the contrary notwithstanding. The property dealt with by the plan, when transferred and conveyed to the debtor or to the other corporation or corporations provided for by the plan, or when retained by the debtor pursuant to the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, and the debtor shall be discharged from its debts and liabilities, except such as may consistently with the provision of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention, and the judge may require the trustee or trustees appointed hereunder, the debtor, any mortgagee, the trustee of any obligation of the debtor, and all other proper and necessary parties, to make any such transfer or conveyance, and may require the debtor to join in any such transfer or conveyance made by the trustee or trustees. Upon the termination of the proceedings a final decree shall be entered discharging the trustee or trustees, and making such provisions as may be equitable, by way of injunction or otherwise, and closing the case. Upon confirmation of a plan the Commission shall, without further proceedings, grant authority for the issue of any securities, assumption of obligations, transfer of any property, sale, consolidation or merger of the debtor's property, or pooling of traffic, to the extent contemplated by the plan and not inconsistent with the provisions and purposes of chapter 1 of Title 49 as on August 27, 1935, or thereafter amended. . . .

Dismissal of proceedings because of undue delay in reorganization.

(g) If in the light of all the existing circumstances there is undue delay in a reasonably expeditious reorganization of the debtor, the judge, in his discretion, shall, on motion of any party in interest or on his own motion, after hearing and after consideration of the recommendation of the Commission, dismiss the proceedings. Upon the filing of such an order of dismissal, all right, title, or interest of the trustee or trustees shall vest by operation of law in the debtor unless otherwise provided by such order. . . .

Restraining or staying commencement or continuation of proceedings against debtor; removal of causes; owners' rights to equipment leased or conditionally sold unaffected.

(j) In addition to the provisions of section 29 of this title for the staying of pending suits against the debtor, the judge may enjoin or stay the commencement or continuation of suits against the debtor until after final decree; and may, upon notice and for cause shown, enjoin or stay the commencement or continuance of any judicial proceeding to enforce any lien upon the estate until after final decree: . . . .

Certified copy of order confirming plan or directing conveyance of property as evidence.

(k) A certified copy of the final order confirming a plan of reorganization, or of any other order or decree entered in a proceeding under this section, shall be evidence of the jurisdiction of the court, the regularity of the proceedings, and the fact that the order or decree was made. A certified copy of an order directing the transfer and conveyance of the property dealt with by the plan as provided in subsection (f) of this section, or as specified in an order dismissing the proceedings as provided in subsection (i), shall be evidence of the transfer and conveyance of title accordingly, and if recorded shall impart the same notice that a deed, if recorded, would impart.

Jurisdiction of court, duties of debtor and rights of creditors same as in voluntary bankruptcy.

(l) In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed. . . .

APPENDIX B

Excerpts from Report No. 925 (Senate) 79th Congress 2nd Session, February 7, 1946.

Investigation of Trusteeships under Section 77 of the Bankruptcy Act and Railroad Equity Receiverships.

We apply italics for emphasis.

Pagings conform to the pagings of the report.

All tables have been condensed to apply only to St. Louis-San Francisco Ry. Co.

(Page 5)

ADDITIONS AND IMPROVEMENTS TO THE TRANSPORTATION PLANT OF THE RAILROADS

The investment per mile of road has increased from approximately $80,000 per mile of road at the end of Federal control to $111,352 at the beginning of the calendar year 1942. This increase is in large part attributable to expenditures for heavier rail, more and improved signal systems, larger and more efficient equipment and machinery, and in no small part to the elimination of some 25,000 miles of the least efficient lines, whose abandonment we had authorized as consistent with public convenience and necessity (pp. 2-3).

(Page 6)

THE PHYSICAL PLANT DURING THE DEPRESSION YEARS

In the case of both the railroads in the hands of the court and those which have remained out of receivership and bankruptcy proceedings, heavy investments in improvements and additions as well as in maintenance, in the war years, have now brought the railroad plant to a higher level.

(Page 21)

REDUCTION OF DEBT

The Interstate Commerce Commission reported to Congress:

During the period January 1, 1932, to December 31, 1941, the funded debt of class I railroads was reduced from $10,850,944,438 to $10,565,084,210, a decrease of $285,860,228. Of this reduction, at least $111,115,727 was effected through reorganization (annual report for 1942, p. 28).

At present, a large proportion of the outstanding railroad bonds can be bought at large discounts. This affords a most favorable opportunity to eliminate debt and to cut fixed charges. The extent to which railroads are now buying their own bonds is not currently reported, but the indications are that substantial operations of this character are, and have lately been, in progress (same, p. 29).

In our last annual report, we again discussed the importance of debt reduction. We suggested that the present favorable earnings be used as largely as is practicable for that purpose. We are convinced that both the public interest and the interest of carrier shareholders will in the long run be served by that policy (same).

For the year 1942 the Commission reported:

It is gratifying to report that more and more railroads in a position to do so are voluntarily reducing or taking steps looking toward the gradual reduction of their funded debt and the burden of fixed interest charges. Some are using their surplus earnings to retire a part of their funded debt or to purchase on the open market their own outstanding securities or those of their subsidiaries which they have guaranteed. During the calendar year 1942 the funded debt of class I railroads and their lessors, excluding companies in receivership or trusteeship, was reduced by $324,375,299, or 3.71 percent. For the operating companies alone the reduction was $282,026,921, or 3.84 percent, and for lessors $42,348,378 or 3.02 percent (annual report for 1943, p. 25).

The Commission's recent annual report states:

> At the close of the year 1935 the amount of unmatured funded debt, including equipment obligations, of line-haul steam railways held by the public (that portion not held by railways) was $11,341,000,000 as compared with $9,312,000,000, as of December 31, 1944, or a reduction in the 10-year period of $2,029,000,000 or 17.9 percent (annual report for 1945, pp. 19-20).

(Page 22)

The report published by the Association of American Railroads in March 1944 and prepared for one of its committees, shows that the funded debt of railways of classes I, II, and III reached a peak of $11,880,000,000 in 1930 and was gradually reduced thereafter, falling to $10,354,000,000 in 1942,, or a reduction in those 12 years of more than one and one-half billion dollars (report, p. 10).

In addition it should be recalled, as noted above, that a number of railways have in recent years been generally making additions and betterments to their properties on a cash basis and without following the usual practice of selling securities to meet the cost of such additions and betterments.

(Page 23)

On the basis of this estimate, the improvement in the position of the carriers in the past 4 years may be totaled, as follows:

Increase in net working capital (p. 3 of Monthly Comment)	$1,125,667,235
Estimated increase due to the 2 tax provisions, and profits of the closing 4 months for 1945, at least.....	1,000,000,000
Total	2,125,667,235

This amount constitutes almost one-fourth of the bond debt of the carriers.

This amount can be used to retire outstanding debt. Very little is likely to be used for capital expenditures. The carriers were polled by the Bureau of Transportation Economics and Statistics of the Commission, and reported that they were expected to spend $1,636,000,000 for road and equipment in the 3 years following the end of the war in Europe and Asia; they reported that they expected to use little of their wartime and prewar earnings to finance such expenditures. (Monthly Comment on Transportation Statistics, December 10, 1945, pp. 1-2.)

REDUCTION IN INTEREST CHARGES AND RATE OF INTEREST

One of the most promising developments for the railroads has been the substantial drop in the cost of money. The United States Government led the way in financing during World War II. The rate of interest for Liberty bonds in World War I was 4¼ percent. In World War II, the rate for long-term financing has been 2½ percent, and as low as 2 percent; the average cost of long- and short-term financing for the Government has been below 2 percent—this in spite of the fact that far larger sums have been borrowed to finance World War II than World War I. The money market is aggressively reducing the yield on the 2- and 2½-percent bonds; their market price is above par, and on many days the increase in price has been the full maximum amount permitted by Government regulations.

Privately owned corporations have benefited from similar reductions in the interest rate on their long-term financing. There has been a large volume of refunding at 3 percent, 2⅞ percent, 2¾ percent, and 2½ percent.

(Page 25)

Interest rates on railroad debt are likely to continue to decline, by reason of a second factor additional to the general decline in interest levels. The large amount of sur plus cash which the railroads possess means that a substantial portion of the outstanding railroad debt will be

retired. *This means that the bonds remaining after such retirement will be both better and scarcer. They will be better because each remaining bon dis secured by more collateral or mortgage value than before, and has access to a larger proportion of the earnings than before. Many of the remaining bonds will also be better because the retirement process has raised their level of seniority.* Retirement of senior bonds converts the junior bonds below them into first mortgage bonds; and so on down the hierarchy of a company's debt. The better the unretired portion of a company's bonds becomes the lower the rate of interest which that company can require in the investment market.

A similar result flows from the other factor already mentioned, the reduced supply of railroad bonds and indeed of all bonds.

The process of refunding to a lower level interest rate will effect a financial change of magnitude for the railroads; the extent of the change is indicated by basic figures published by the Western Railways and by the Eastern Railroad Presidents Conference in the 1944 edition of A Yearbook of Railroad Information (pp. 22, 42). These figures show that the total funded debt of the class I railways in 1942 (the latest year listed in those statistics) was $10,354,041,681 and that the total interest in that year on funded debt was $483,000,000. This constitutes an average interest rate slightly in excess of 4.65 percent. A cut of the average interest rate of 4 percent would effect a reduction in the annual interest charges of $68,336,000. A cut to 3½ percent would reduce the annual interest charge $118,513,000. A cut to 3¼ percent would reduce the charge by $143,601,000. A cut to 3 percent would effect a reduction in the annual interest charges of $168,689,000.

(Page 26)

On the subject of possible savings in interest charges, this committee has received from the Interstate Commerce Commission, in response to our request, data on 23 roads

now in the hands of the Federal courts, or recently undergoing reorganization proceedings. Nine of the largest of these companies are still in court hands, in receivership or trusteeship; a tenth has emerged or is in the process of emerging from court hands; their aggregate operated mileage, as reported by the Commission (annual report for 1944, p. 146) is some 43,340 miles; if their interest charges were reduced to 3¼ percent (the "lower level rate" or average interest rate of the railway bond flotations between January 1, 1944, and June 30, 1945), those 10 systems would save about $30,205,000 per year. The amount of such potential annual savings, and the percent by which the 1944 total annual interest charges would be reduced through such savings, are here given for each of the 10 companies:

Name of company	Annual savings in charges if interest on bonds were reduced to lower level rate	Percentage of reduction of present total interest charges
• • • • •		
St. Louis-SanFrancisco Ry. Co.	$3,094,386	26

Source: ICC, table VI, C. 8.

(Page 27)

The completion of the program of reducing the interest rate paid by these and all other railways will constitute a fundamental reorganization of their finances. It can produce financial changes adequate for the needs of the railroads. *The process, furthermore, is in contrast to the drastic process usually involved in reorganizations in equity receivership and under section 77 of the Bankruptcy Act. It is a business process in contrast to a Government-imposed process. It stems from the market place rather than from governmental agencies. The possibility of effectuating such a program may well be regarded as one of the greatest assets of the railroad industry.*

However, in a number of these railroads this process could have been carried much further. A number of receivers and trustees have been inclined to hold cash and cash equivalents in far larger amounts than were needed or could be justified by sound business practice. It is necessary to convert more rapidly from the theory and practice in insolvency proceedings of withholding payment of interest and retirement of bonds, to the sound business practice of paying interest and retiring principal when funds are available for those purposes. It is now clear that the conversion to the normal process of paying interest, past and current, and retirement of principal, can be carried much further than has been the case up to the present.

Sound railroad finance requires the prompt retirement of debt through the use of the over-abundant funds which are now being held by many of the receivers and

(Page 28)

trustees appointed by the Federal courts. It is true that the receivers and trustees invest a portion of their large surplus funds in short-term government obligations which yield a fraction of 1 percent per year. However, the receivers and trustees are in a position to retire large amounts of debt, bearing coupons of 4 to 6 percent. The net loss to the railroads is, therefore, considerable—and unnecessary. *It is possible that some receivers and trustees have found it difficult to use the surplus funds as fully as they might have desired because they felt that this might interfere with some pending plans of reorganization or with negotiations among groups of security holders. However, no such circumstances would seem to justify a departure from the requirements of sound business practice which should govern all such questions. The reorganization plans are subject to revision, and even to abandonment, as experience demonstrates; legislation may affect their course also.*

Meantime unnecessary interest charges accrue, or are paid. The industry can be greatly advantaged by using the surplus funds without further delay, for reduction of debt.

	Net interest rate which could have been saved	Net amount of interest which could have been saved, computed on an annual basis
	Percent	
• • • • •		
St. Louis-San Francisco	3.83	$591,532

Source: ICC table VI, C 5 (8).

(Page 29)

The amount of surplus funds, available for reduction of debt, is far larger today than it was at the end of 1944; and the amount of interest charges which could be saved if the surplus were energetically applied to retirement of debt is far larger than in 1944. Reference has already been made to the large cash accumulations of 1945, resulting from the net income of that year, and the tax provisions with respect to amortization and refund of 10 percent of excess-profits taxes.

Reference was made above to the payment of interest charges, both current and accured, by companies in the hands of the courts. Large amounts have been paid by the trustees and receivers, pursuant to court orders. Justice to the bondholders required such action, and entitled them to have such payments made larger, in order to clear up all arrears, and to provide income to junior bondholders, where they have received no payments of interest, or relatively small amounts of interest.

However, justice to the companies and their shareholders makes some adjustment appropriate. The Reconstruction Finance Corporation has already pointed to *the fair course, that of reducing the amount of interest demanded by it, from the full figure fixed in its notes, to a lower rate made appropriate by financial conditions, usually for 6 percent to 4 percent; and, as we note later, this process might even be carried further, in full recognition of current money rates. Similarly, if these companies*

were no longer in the hands of the courts (and, as noted later, there is only a technical basis, and often not even such a basis, for continuing a number of them in the courts), many of them could refund their outstanding bonds at considerably lower rates of interest. It is desirable, until the necessary steps can be taken to remove them from the courts, to have such adjustment made, so as to eliminate any suggestion that unfair advantage accrues to any set of security holders by reason of artificial restrictions. On the other hand, once such adjustment is made, it would seem only fair to clear up, on that basis, all arrears to the fullest extent permitted by the surplus funds.

The Bureau of Transport Economics and Statistics of the Interstate Commerce Commission has made a study of the contrast between interest charges payable by roads not in court hands and by roads in receivership or trusteeship. The fixed interest charges for the latter in 1944, as compared with 1940, increased 4.1 percent, and for the former decreased 12.5 percent (Monthly Comment on Transportation Statistics, March 7, 1945, p. 5). *It does not seem appropriate that in payments received and to be received, roads in the hands of the courts should be subjected to abnormal interest burdens, paying higher interest than is paid by other roads.*

While, of course, it is not suggested that any of the parties have intended to bring about such a result, it is nevertheless true that in its nature the result is akin to one of the most widely criticized features of the small-loan business of earlier days—the borrower who is in distress is made to overpay; *is, in effect, gouged. The artificial restraint on carriers subject to section 77 procedure, which was evolved for conditions far different from those now prevailing, should no longer be permitted to effect such unsound and unjustified disadvantage and damage to those companies.*

Companies which have any financial problems to solve could advance the solution of their difficulties by reducing their interest rates. The public in general will be benefited,

as was indicated by the president of the American Short Line Railroad Association at the hearings on S. 1253, as follows:

> As a help in meeting such a situation we are sure that a reduction in the cost for debt—in other words, the cost of debt service—could in many cases serve a very useful purpose, and entirely in the public interest, without unfairness to a minority (pp. 121-122).

(Page 30)

Yet, the interests of the railroads in the custody of the courts, and in the interests of the public as well, have been retarded, not advanced. The companies which would be most benefited by reduction of their interest rates are the very companies which are being prevented from securing a reduction.

In all such matters, the need is apparent for an advance in financial techniques comparable to the great advance made in railroad operating techniques. The former have not kept pace with the latter; there is considerable question whether there have been more than mere stirrings or beginnings of improvement in dealing with financial problems as required by sound business considerations. An example is presented in data furnished by the Interstate Commerce Commission in response to this committee's request. The example relates to the Chicago & North Western Railway Co. It was reorganized in June 1944. Reorganization obviously offered an opportunity for adjusting interest rates to current and oncoming interest levels. Some $54,000,000 of reorganization bonds were issued in July 1944, bearing *interest rates of 4 percent. Within a few months* the directors of the reorganized company took the necessary steps to bring about a refunding of those bonds, by a new *issue at 3 per cent*—a saving of over half a million dollars in interest charges per year (ICC table III). But meantime the railroad had to pay the extra amount of interest, and the charges for bankers' and distributors'

commissions and profits had to come out of the pocketbooks of the railroad company and investors.

The financial staffs of the Government agencies, railroad companies, committees, and other groups interested in the general problem possess the ability to bring to bear on this problem the same resourcefulness which engineering and similar experts and the operating managements and employees of the railroads have used in the operation of

(Page 31)

the transportation plans. Indeed, the financial problems are much simpler. *One may be confident that once the experts and interested parties are permitted to keep up, in financial developments, with the practical men engaged in railroad operation, the roads and the Nation, as well as the investors themselves, will reap substantial benefits.*

(Page 39)

The following data, dealing with eight major railroads in the custody of the bankruptcy courts, all but one still there, are taken from the elaborate tables prepared by the Interstate Commerce Commission.

For period from Jan. 1, 1941, to June 30, 1945—average per year

Name of railroad company	Number of times average annual interest charges were earned*	Dollars earned per share of stock	
		Preferred stock	Common stock
• • • • •			
St. Louis-San Francisco	1.99	67.04	34.53

* The accounting rules of the Commission provide for the deduction of all taxes before considering the amount earned and available for payment of interest. In computing the number of times the annual interest or fixed charges were earned, financial manuals consider earnings before deduction of Federal income and excess-profits taxes, as well as after such deductions. The Commission has stated that net income before such tax deduction indicates certain earning power (annual report, 1944, pp. 7-8). The comparison in this and later tables computes times earned on the same basis for all companies.

Source: ICC, table VI C 1.

(Page 44)

The net income figures for 1945 will not be comparable with those for prior years. A very large amount of amortization, in excess of normal depreciation rates, has been deducted as an operating expense, in order to obtain benefits under the tax law. Most of this deduction represents a tax saving of 85½ percent of the amount deducted. The total deducted by way of amortization probably runs into hundreds of millions of dollars.

Part of this sum may be deducted as an expense in preceding years, necessitating a revision of the back figures of net income for those years as well.

The total cost of wartime facilities certified, so as to be amortizable under the tax law, is believed to be about one and one half billion dollars. If depreciated at the normal rate, say, 3.41 percent—a figure mentioned earlier in this report—the amount of depreciation chargeable annually as an operating expense would be about $51,100,000. The actual figure would be somewhat less, since depreciation of roadways and structures is not charged as an operating expense, and part, though a smaller part, of the facilities under discussion were roadway and structures. Whatever the precise amount, it is far less than the amount of amortization actually deducted as an operating expense for 1945 and two or more preceding years. The excess constitutes an arbitrary understatement of the earnings of those years.

On the other hand, the book figures for net income of postwar years will be higher to the extent that depreciation, otherwise chargeable as an expense, will not be charged on those installations for the many remaining years of their life.

YEARS SUBSEQUENT TO 1945

In discussing business of the years subsequent of 1945, it is possible to make estimates of their probable earnings or to limit discussion principally to those facts which

are in the realm of certainty rather than in the realm of forecast. We shall limit our own discussion primarily to known facts and certainties with respect to the business of the several years following 1945.

(1) One established fact is that large bodies of troops, and large quantities of surplus goods released by the War and Navy Departments and of war material will have to be transported by our railroads.

As the Commission reported on November 2, 1945:

> * * * the cessation of hostilities has not brought strictly war demands to an end (annual report for 1945, p. 1).

(2) Another established fact is that the period of reconversion has already been under way for some months and that there is a large pent-up demand for civilian goods both on the part of returning members of the armed forces and on the part of the civilian population.

In the 1945 edition of A Yearbook of Railroad Information issued by the Western Railways and by the Eastern Railroad Presidents Conference, this subject is discussed as follows:

> World War II has ended. War production has been cut back or terminated, but large quantities of war materials in both theaters will be returned to the United States and transported by rail to arsenals and points of disposal. So long as large military forces remain in the European and Pacific areas, there will be a heavy movement of supplies and military personnel in both directions. Occupational forces also will require food and supplies. China's needs probably will be substantial and there will be continued heavy relief

(Page 45)

> shipments to the devastated countries in both theaters of war. Demobilization, at the rate of 500,000 persons a month, will demand considerable rail transportation.
>
> Unlike other industries, the railroads have no re-

conversion problem. Their plant in war is the same as in peace. During the war, the railroad plant was able to handle both military and civilian traffic. With the decline in war traffic it is ready to move the increase in traffic that will result from the resumption of civilian production (p. 1).

(3) A third known fact of considerable importance is provided by the carry-back provisions of the tax laws. These constitute in effect a guaranty of minimum normal earnings for the railroads for 1946.

On the subject of carry-backs and carry-overs under the tax law, the Bureau of Transport Economics and Statistics of the Interstate Commerce Commission made some valuable comments in its June 5, 1944, Monthly Comment on Transportation Statistics. The Bureau said, in part:

(Page 47)

Excess-profits taxes of class I line-haul railways, year ended Dec. 31, 1944

Region and railway	Amount
* * * * *	
St. Louis-San Francisco*	$9,829,000

(Page 49)

While under the restraints and disabilities inherent in control by bankruptcy courts, these railroad systems have abundantly demonstrated their solvency. *They have overcome their financial difficulties to the point where the facts of solvency are opposed to the forms of insolvency.*

(Page 50)

UNPAID INTEREST CHARGES

There was some discussion at the hearings on the question whether a court has the power to discharge a company from section 77 proceedings under such circumstances. The counsel for the savings banks confirmed the chairman's opinion, as follows:

* Report of trustee or trustees.

> **Mr. Oliver.** Mr. Chairman, you are exactly right in saying that the courts have the inherent right to dismiss proceedings, and Commissioner Mahaffie tells me that that has been done in one case of a small railroad (hearings, p 76).

Reference to one such case was made in the Review of Railway Operations in 1944 issued by the Bureau of Railway Economics of the Association of American Railroads (p. 26). The association's report states:

> * * * the court discharged the debtor company from trusteeship on a showing that its improved financial condition made unnecessary the continuation of such proceedings (p. 2).

(Page 51)

Some companies still in the hands of the courts are not presently able to pay their past-due interest but could have done so if their finances had been ordered in the same manner as if they had not been under court control in recent years. As a result of the action of the courts, and of the receivers and trustees appointed by them, funds which could have been used to pay past-due interest or to retire principal obligations were employed for surplus maintenance, or to purchase equipment for cash, or otherwise for purposes which were in effect the substitutions for paying off part of all the overdue interest.

In considering whether railroads which are in the hands of the Federal bankruptcy courts are now solvent, one assumes that the bankruptcy courts should have been desirous of so handling the affairs of these railroads as to overcome any condition of bankruptcy and to restore them to a condition of solvency; and it is assumed that to achieve this desirable end, the bankruptcy courts should have desired to conduct the affairs of the railroads as effectively as the railroad companies themselves would have done if they, instead of the bankruptcy courts, had been in control of their properties during recent years.

Following this customary practice of railroad companies, most of the important railroads whose properties are at present in the hands of the bankruptcy courts, if the companies had been in control of their own properties, would by this time have been able to *pay all interest they owe for any past years right up to date.* They would have been able to do even more than this. They would in addition a large surplus amount of cash which they could either keep in their treasuries or could have used to pay and retire their bond issues and pay for some of the additions and betterments without any new financing whatever. This surplus amount which they could have so used after paying all their interest right up to date aggregated, on December 31, 1944, for seven important railroads, six of them still in the control of the Federal bankruptcy courts, approximately $317,000,000; as of the present time the aggregate is far greater.

(Page 52)

If these railroad companies had been in charge of their own properties they could have *undoubtedly refunded some of their bond issues at lower interest rates.* Had this been done for the year 1944 alone, by a reduction in interest rates to the lower level rate (the average interest rate on bonds floated from January 1, 1944, to June 30, 1945), the surplus amount after paying all interest charges up to date would have been $24,000,000 more or a total of $341,000,000. The amount in the cash saving of each of the above roads for 1 year alone would have been as follows:

* * * * *

St. Louis-San Francisco..... $3,094,386

Source: ICC table VI-C-8.

The ability of companies now in section 77 proceedings to pay all their overdue interest, if they had been allowed to follow the usual procedure of railroad companies which are in charge of their own properties, may be further studied by comparing the amount of matured unpaid interest as of December 31, 1944, with four other items which appear in the data furnished to this committee by the Inter-

state Commerce Commission. Those items show the amounts expended by the courts out of the funds of the railroad companies above listed, for additions and betterments during the period of the bankruptcy proceedings, the amounts similarly paid by the courts to reduce the long-term debt of the companies, the increase in the net current assets of the companies during the bankruptcy proceedings, and the postwar refund of excess-profits taxes payable to these companies as of December 31, 1944. The aggregate of these four sums exceeds the total amount of matured unpaid interest, as of December 31, 1944, by 63 percent.

(Page 53)

(In millions of dollars)

* * * * *

St. Louis-San Francisco:

Matured unpaid interest at Dec. 31, 1944	96
Amounts expended by the courts during the bankruptcy proceedings to Dec. 31, 1944	54
Decrease in long-term debt during bankruptcy to Dec. 31, 1944	34
Net current assets as of Dec. 31, 1944, in excess of net current assets at close of year preceding bankruptcy	24
Postwar refund of excess-profits taxes as of Dec. 31, 1944	....
Total of preceding 4 items	112

Source: ICC, tables VII and VIII.

Even if the companies in section 77 proceedings would not have been able to pay all matured interest, their situation is nevertheless so good that it calls for a business rather than a court solution. If they were not now in court hands, it is unlikely that their present condition would lead their managements or their creditors to go to court for receivership or section 77 proceedings. Their affairs are in good shape, their past-due interest is, relatively speaking, sufficiently within the range of reasonable arrangement, and their present surplus and prospects for surplus in the next few years available to meet the remainder of the overdue interest are sufficiently good. Furthermore, the very fact, above noted, that bondholders of such companies have been receiving interest at rates fixed years ago instead of at the much lower level which the current money market

calls for, would, if taken into consideration, help considerably in solving the present financial problems of those roads by ordinary business adjustments rather than by court proceedings. In the case of such companies, it is fair to say that their insolvency is what might be called of a technical nature rather than genuine insolvency.

(Page 54)

The following figures, furnished by the Commission, demonstrate that in the case of seven major companies the net current assets (the excess of current assets over current liabilities) at the end of 1944 were 64 percent of the interest in default at that time:

(In millions of dollars)

* * * * *

St. Louis-San Francisco:

Matured unpaid interest at Dec. 31, 1944 96

Net current assets at Dec. 31, 1944 25

Source: ICC, table VII.

A comparison of the amount of matured unpaid interest with the cash on hand (including cash equivalents in the form of short-term Government paper and the like) is even more striking. The cash on hand at the end of 1944 exceeded the total amount of matured unpaid interest. The figures, again in millions of dollars, are as follows:

(In millions of dollars)

* * * * *

St. Louis-San Francisco:

Matured unpaid interest at Dec. 31, 1944 96

Cash and cash equivalents on hand at Dec. 31, 1944 40

Source: ICC, table VII.

The foregoing figures though impressive in themselves, are less striking than will be the figures (still to be gathered and published) as of the end of 1945. At the end of 1945 the net current assets, the cash on hand, and the income

(Page 55)

available for payment of interest will have greatly increased by reason of the profits of the year 1945. In addi-

tion, the net current assets and the cash on hand available for paying matured unpaid interest will have vastly increased by reason of the provisions of the tax law discussed elsewhere in this report. Those tax provisions will probably enable the railroad industry to have net current assets, as well as cash, greater than would otherwise have been the case, in the amount of $1,000,000,000, if not more. Mention has been made of the cash which will be retained by the companies under the amortization provisions of the tax laws. In addition, there is the tax-refund provision.

Many of the companies still in the hands of the courts (as well as many of the other railroad companies) received from the Federal Government at the end of 1945 large sums in the form of a refund of 10 percent excess-profits taxes paid to the United States Treasury during the present decade under section 210 of the Internal Revenue Code. Seven railroad systems in court custody paid, in 1944 (the year for which the separate figures for each company have been published), about 14 percent of the industry's $1,000,000,000 excess-profits taxes.

In brief, the only basic obstacle to the release from court, without any Commission proceedings or court reorganization, of various major railroads now in court control *is their unpaid, overdue interest;* the companies, *if they could have used their funds, could have paid all this overdue interest, but the courts and court-appointed trustees, having control of the companies' funds, used them in par for other purposes;* in any event, the earnings and the liquid resources of these companies, together with favorable money market conditions, would enable them to handle the problem of overdue interest in a businesslike way—if they were free from the section 77 *proceedings and procedures which in fact tie their hands.*

It is important to avoid the assumption that two quite different conditions are in fact one and the same. A *company's temporary inability to pay interest charges is not synonymous with worthlessness of the company's stock*

which, by definition of the Interstate Commerce Commission, means that the stock is a nonearner).

SECTION 77 PROCEEDINGS

Subsequent to the enactment of section 77 for railroad reorganization and the entrance of a number of systems into court custody under that statute, the theory was developed that companies in section 77 proceedings require drastic reorganization; contrast was made with companies in proceedings under the Chandler and McLaughlin Acts (ch. XV) which provide for mild reorganization. *Under the latter, stocks are not wiped out, whereas under the administration of section 77 they are usually wiped out. Thus, on the surface it might appear that companies in section 77 proceedings are likely to be insolvent companies, while those under chapter XV are solvent companies.*

Testimony at the hearings on S. 1253 indicates that this is incorrect, and that the assumption is not justified that companies in section 77 proceedings are inherently weak and more in need of drastic reorganization than other companies.

(Page 56)

In those years the statutory procedure was under section 77. Chapter XV was not enacted until 1939; thereafter major roads in need of statutory aid resorted to its procedure rather than to section 77. The need for such aid usually arose out of the fact that a company's bonds were about to mature, or would mature within a year or two, in a period when refunding was not available to it. This is what forced the Baltimore & Ohio to resort to chapter XV; testimony to this effect was given by the representative of the insurance companies (hearings on S. 1253, p 30). The maturity dates of companies' bonds, frequently responsible for decisions, both before and after 1939, to seek statutory aid, were fixed many years earlier, when the bonds were created. This coincidence, rather than in-

herent weakness, brought various major roads under section 77.

On this the following testimony was given by Mr. Purcell, vice president and general counsel of the Chesapeake & Ohio Railway:

> Most of the railroad bankruptcy reorganization proceedings have been caused by impending maturities of one or more bond issues during a period of depressed earnings when railroad credit was inadequate to permit of their refinancing. I look back to 1937 when the Nickel Plate Road was confronted with maturities of its Lake Erie & Western first mortgage bonds and Nickel Plate first mortgage bonds. You will recall that 1937 was a good year for railroad earnings. Fortunately, Nickel Plate was able to refinance. Had these bonds matured in 1938, a year later when railroad earnings were at a low ebb, Nickel Plate would surely have gone into bankruptcy. Certainly its common stock, probably its preferred stock, and possibly its outstanding unsecured notes would have been eliminated from any participation in a bankruptcy reorganization plan. Yet today the common is selling at more than 50, the preferred at 130, and the unsecured notes have been paid in full. What a vast difference resulted from the pure coincidence that those who decades ago caused the issuance of these bonds selected a maturity date in 1937 rather than in 1938.
>
> * * * *
>
> Similarly, we can all thank our lucky stars that the Pere Marquette, about two-thirds of whose common stock is owned by Chesapeake & Ohio, was not confronted with maturities during the thirties when its then outstanding high-interest bonds were selling at very substantial discounts.
>
> * * * *
>
> We look back today and are extremely thankful that those particular bonds, by the rarest coincidence,

came due in 1937, because the Nickel Plate's credit in 1936 and prior years, and in 1938 and subsequent years, was not such as would have made it possible to refinance those obligations in any year during the thirties other than 1937.

• • • •

(Page 57)

So that the Nickel Plate was saved from bankruptcy by the mere happenstance that someone, many decades before, who had created that bond issue, caused it to come due in 1937.

The misconception that the roads under section 77 procedure need that procedure, and in this respect are unlike those which have had the benefit of the milder procedure of chapter XV, may be studied in the light of data furnished to this committee by the Interstate Commerce Commission. These data dispose conclusively of the view that the former roads are essentially weaker than the latter or than their financial structures are fatally weak.

We shall consider first the more important of these two criteria, the ability of the roads in section 77 procedure to earn their interest charges, as compared with those which have proceeded under chapter XV. *The number of times that the annual interest charges are earned is a test not only of the solvency of a railroad, but of the quality of*

(Page 58)

its bonds; State laws apply this test to make sure that only safe railroad bonds are purchased by insurance companies, savings banks, and trustees for minors and others. In the testimony before this committee, a vice president of the Metropolitan Life Insurance Co., speaking in another connection, used this test to indicate the inherent soundness of the bonds of a temporarily distressed railroad company (hearings, p. 30).

The data furnished by the Commission at the request

of this committee take a period of 5½ years, January 1, 1940, to June 30, 1945. In that period, the net earnings before interest and Federal income and excess-profits taxes were more than enough to pay the interest and taxes of those years, both in the case of roads under section 77 and those under chapter XV; in fact, the interest charges for many more years than those 5½ years could have been paid out of those earnings. The number of times average annual interest charges were earned per year during those 5½ years by roads which have proceeded under chapter XV appears in the following table:

Baltimore & Ohio	2.19
Boston & Maine	2.28
Colorado & Southern	1.66
The Delaware & Hudson	2.43
Lehigh Valley	1.95

The comparable figures for major roads under section 77 proceedings are:

Chicago, Milwaukee, St. Paul & Pacific	1.83
Chicago, Rock Island & Pacific	3.21
Denver & Rio Grande Western	2.16
Gulf Coast Lines (5 years only)*	3.90
Missouri Pacific	2.79
New York, New Haven & Hartford	2.64
St. Louis-San Francisco (5 years only)*	1.86
St. Louis-Southwestern Railway System	6.98

Source: ICC table VI-C-1.

The average for the latter companies is 3.66, for the former it is 2.52. Thus, both when compared individually and collectively with the roads under chapter XV procedure, those which went into reorganization under section 77 prior to the enactment of chapter XV show up favorably;

*Omits first half of 1945.

collectively, they make a 68 percent better showing, on this all important test.

The data furnished by the Commission, of earnings per share during this same 5½-year period, are as follows:

(Page 59)

The comparable figures for major companies under section 77 procedure follow:

Earnings per share

* * * * *

St. Louis-San Francisco System (5 years only):*

Preferred stock	$67.70
Common stock	37.27

Source: ICC table VI-C-1.

Excess profits taxes in 1944—per share of common stock

* * * * *

St. Louis-San Francisco System:

Excess-profits tax, per share	$16.07

Source: ICC table VI-C-1; Monthly Comment, March 7, 1945, p. 3.

(Page 60)

The earnings per share of common stock are here given.

In the following list, three of the companies have already been reorganized under section 77; the figures are on the basis, not of the new capitalization, but of the capitalization prior to reorganization, and show the earnings on the shares wiped out under the reorganization plans.

Earnings per share of common stock of major railroads, 1941-44

(1) In Section 77 Proceedings

* * * * *

St. Louis-San Francisco System	$37.27

(Page 61)

These figures may be considered on various bases—company by company, or average of the first 10 compared with the average of the second 10, or geographically.

Taking the averages, the section 77 roads show an av-

*Omits first half of 1945.

erage of $59.09 per share, the roads not in any court proceeding show an average of $54.70 per share.

On a geographical basis, we may take the three sections in which major roads under section 77 proceedings operate—northwest, southwest, and east and middle west.

These comparisons are important with respect to the problem raised by forecasts which decree that companies are insolvent, and that their stock is worthless. The question is not whether the stocks of railroads in section 77 proceedings are worth less than at the time when they were created, or are worth less than the stock of sound companies which are not in any court or Commission reorganization proceeding, except as a comparison highlights the essential solvency of the former companies and that their shares have earning power and value. When a Government decree wipes out the shares of stock of companies in

(Page 62)

section 77 proceedings, the decree is not that the shares are worth less than those of other companies, but that they are utterly worthless.

Comparison between the two groups of roads above listed, those in section 77 and those which are not in any reorganization, may also be made with respect to the excess profits they paid per share of common stock.

The comparison is even more revealing when each group is taken as a whole. For the 10 roads not in reorganization listed above, the average of excess-profits taxes accrued for 1944 was $23.31 per share of common stock. For the 10 roads in section 77 proceedings, the average was $34.35 per share of common stock. The roads in the hands of the courts thus accrued an average of 46 percent more excess-profits taxes per share of common stock than the comparable roads not in court hands.

The share of the section 77 railroads above listed compare favorably with the shares of the strong roads not in court proceedings both as to net earnings per share

after payment of taxes and deduction of all charges, and as to earnings per share set aside for excess-profits taxes.

The figures on excess-profits taxes per share of common stock have a special bearing on the question whether they are likely to have earnings in later years. As the Commission reported to Congress in 1944, "*the net income before deduction of income and profits taxes deserves attention as indicating the earning power of a railroad with the existing rates, fares, expenses, and traffic volume*" (pp. 7-8). Since income taxes have not been greatly reduced, and excess-profits taxes have been eliminated, it may be useful to limit a study of the per-share earnings for 1944 to consideration of the net income actually earned, and the excess-profits taxes per share. The figures for the major roads in the section 77 groups follow:

(Page 63)

1944 earnings per share of common stock

* * * * *

St. Louis-San Francisco System:

Net earnings per share	$ 5.21
Excess-profits taxes per share	16.07
Aggregate of earnings set aside for excess-profits taxes, and net income per share	21.28

Source: ICC table VI-C-1; Monthly Comment, June 6, 1945, p. 6.

These figures are large; the earnings of the companies would have to drop to a very low point, and would have to stay that low, year in and year out, before one could say that the common shares of these companies can have no earnings at all in future years.

The data presented above deal only with the common stocks. Even if there were a certainty that they could earn nothing in the future, there would still be the question whether the preferred shares could have no earnings in the future; obviously, unless it can be demonstrated that the preferred stock will have no earnings, it may not be assumed that the companies are insolvent. Nine of the ten companies in the section 77 list above set out had preferred

stock outstanding, and made large earnings per share of preferred.

The comparisons above presented, with roads which are not in reorganization proceedings, may be amplified in one important particular. Those roads paid dividends in a number of instances for each year of this decade, in other cases for part of the period. Dividends were not paid during the period on the stocks of the roads in section 77 proceedings.

This does not indicate that the one class of roads is solvent and the other is insolvent, or that the shares of the one have value, and the shares of the other are valueless. In chapter XV proceedings, where the stock is saved and is regarded as valuable and the companies are regarded as solvent, limitations are placed on the payment of dividends.

Indeed, the fact that for a period of time dividends were not paid only makes the assets of the companies larger, and their shares more valuable.

(Page 64)

ADMINISTRATION OF SECTION 77 PROCEEDINGS BY THE COMMISSION

With exceptions relating to a very small proportion of the affected railroad stocks, *most of the plans of reorganization issued by the Interstate Commerce Commission in major cases arising under section 77 proceedings*

(Page 65)

have treated the railroad systems under that section as insolvent. The plans have proposed that the preferred and common stocks of the companies be wiped out, on the ground that the companies cannot earn enough in the future to provide any yield or income on the stocks.

The issue which the Commission decided in these cases was not whether there are earnings on the stocks of these railroads at the present time; the decisions, as will appear

shortly, *were made in earlier years.* If the issue were, whether there *are present earnings,* the answer would be obvious—there are big earnings on stocks—i. e., these stocks now have a value—i. e., *the railroads are not insolvent.*

The issue the Commission considered in these cases was whether the railroads would in the future earn anything on their present stocks. That, in the Commission's opinion, was its duty under section 77—to fix, for the companies under that section, a new capitalization based *upon its estimate of the future earnings of those companies.*

The performance of such a duty confronted the Commission with a dilemma, which makes clear the injustice to any agency charged with such a duty. On the one hand, if estimates of future earnings for purposes of new capitalization must be made, it is convenient to incline to the conservative if not the ultraconservative side; it is only natural to err in the direction of underestimating future good news about earnings, rather than the opposite. On the other hand, there is much to be said for the investors who urge that their property should not be foreclosed, that estimates made in 1939 and 1940 that the companies will not be able to earn anything on their stock have *already been shown to be unduly low,* and that in any event it is dangerous for anyone, particularly for a Government agency, to *destroy the property and investments of investors simply because the Government, no matter how well intentioned, estimates that at some time in the future there may be no income on those investments;* the stockholders ask why their securities, which are now, *and for* some *years have been, big money makers, should be now destroyed by Government fiat as presently worthless because a Government agency estimates that at some time in the future these securities will not be money makers.*

The nature of such forecasting is indicated in one of the Commission's decisions less than a year ago, when it said: "Any estimate of future traffic and earnings is, of necessity, speculative" (*Baltimore & Ohio Railroad Debt Adjustment,* 261 I. C. 51, 81).

What the Interstate Commerce Commission has felt that it does in making the estimates which are the foundation of its orders to wipe out stockholders was recently explained by Commissioner Porter, the chairman of its Finance Division, in testifying on H. R. 4779. The process is one, to quote his testimony, of "*making intelligent guesses. For this purpose, we studied the past history that was before us, we had the testimony of men who were regarded as in a position to make the most intelligent guess as to what the future might hold. And starting from that complete record up to the minute that it was submitted to us, we tried to make up our minds as best we could on that*" (hearings, December 18, 1945.) The Commissioner emphasized that the Commission looked to past years, and

(Page 66)

weighed in addition the testimony of men who were regarded as experts in making their prediction as to what the future might hold.

At the same time that the Commission recognized the impossibility of making a forecast, it believed itself compelled, under section 77, to make forecasts, and it was at that very time engaged in proceedings to arrive at forecasts. Its forecasts were made in all important cases in 1939 and 1940, as indicated by Commissioner Mahaffie to the committee considering H. R. 4779. *In some of the cases the plans were later revised, but the capitalization proposed*

(Page 67)

by the Commission in 1939 *and* 1940 *was not changed in most of the larger cases, and if changed in any of them, the change was minor.* The Commission's estimates of the long future, on which its proposals of capitalization were based were, so far as based on actual known earnings, made in the light of earnings to the end of 1937, and in a few cases to the end of 1938 or possibly after looking at preliminary figures for earnings in the first few months of

1939; substantially speaking, when it fixed the capitalization in the larger cases, it had before it the actual earnings up to the close of 1938—*the time when it frankly advised Congress of the impossibility of forecasting for the long future.*

The forecasts made in those years, with the resultant proposals to eliminate 2½ billion dollars of securities, and to decree which security holders should be deprived of their securities, could not, of course, have the benefit of knowledge of fundamental changes of the near future. The hearings on S. 1253 treated of this fact, as follows:

> The Chairman. Let me ask you this: Of course, when the Interstate Commerce Commission set forth their plans, they did not contemplate, or did not think these railroads were going to have this windfall to them on account of the war.
>
> Mr. Hagerty. That is right.
>
> • • • •
>
> Mr. Hagerty. The conditions were quite different when the Interstate Commerce Commission approved these plans * * * (hearings, pp. 34, 35).

In responsible quarters other than the Commission the same difficulty of making such forecasts has been experienced. Thus, during the war period pessimism about the future earnings of the railroads was based on various assumptions about the future. It was assumed that the railroads would in the future be subjected to a great increase in taxes; this expression was made at a time when the railroads were subject to 95 per cent excess-profits tax, the highest in their history. In the very year when such a future setback of their net income was being envisioned, 47 percent of the total tax bill of the railroads was due to the excess-profits tax—now eliminated; 21 percent of their total tax bill was due to the Federal income tax—now reduced in rate. In the following year these two Federal taxes were responsible for more than 70 percent of the railroad industry's total tax bill. A considerable por-

tion of the balance of their taxes fluctuates, as does the income tax, with the volume of their business, so that the larger the amount of such taxes paid by the railroads, the larger their net income (Statistics of Railways of Class I, calendar years 1929 and 1936 to 1945, Statistical Summary No. 29, prepared by Association of American Railroads, October 1945, at sheet 11).

Pessimism, similarly arising out of the inherent difficulty of prophesying, was based, in *quarters outside the Commission, on the assumption that the years after World War II would resemble those immediately after World War I.* In the actual event, when World War II came to an end, *it was found that the assumption earlier made was the exact contrary of the facts—the physical and financial condition of the railroads today is extraordinarily good, compared with their extraordinarily bad condition in 1918 and for some tme thereafter.*

Doubts about the future have also been based on the assumption that there would be a great increase in operating costs—*though improvements and constantly increasing efficiency now point in the opposite direction.*

(Page 68)

A fourth example may be mentioned. It has been assumed that reduced interest charges in the future support pessimistic prophecies about the future earnings of roads whose fixed charges are decreased. Those who make that assumption state that the less the interest charges, the less the deductions from gross revenue, for income-tax purposes, and thus the larger the income tax paid. Such forecasting overlooks the fact that net income increases as interest charges decrease, and would regard one of the greatest blessings that the industry can look forward to, as a disadvantage.

In short, others who have undertaken to forecast in this field have had the same experience as the Commission has had, in discharging the duty of forecasting which it

believes has been imposed on it by Congress. This duty, as demonstrated by the experience of others besides the Commission, is one which should not be imposed on a *Government agency, when the inevitable consequence of pessimistic forecasts is the destruction of existing property rights.*

The Commission, in its forecasts, sought to be conservative (*Western Pacific Railroad Company Reorganization,* 230 I. C. C. 61, 87). It is, of course, conservative to forecast one's own future income pessimistically rather than optimistically, when contemplating one's future expenditures for, say, luxuries. But there would appear to be some justification for the view of junior security holders that, if the consequence of *one's forecast is to wipe out another person's investments, the forecast which is conservative in the eyes of the forecaster is radical in the eyes of the investor—more than radical; it is destructive of his property rights.*

The soundness of the Commission's warning to Congress about the impossibility of forecasting future earnings was demonstrated every year after it had issued its conservative forecasts that the companies would not earn anything on their stock, with the consequence that the stocks of those companies must be destroyed. Since the completion of its forecasts and orders to wipe out the stocks of the major railroads in section 77, every one of those railroads has earned large sums on its stock every year (except two of the companies, which missed out in 1941 and only in that year).

The entire series of forecasts in nine major cases, with the conclusion that the stocks would have no earnings in the future and must be destroyed, was completed by 1941; most of the decisions were made in 1939 and 1940. The dates follow:

* * * * *

St. Louis-San Francisco..... July 6, 1940

Source: Hearings on H. R. 2857, p. 197.

The earnings on the stock of these companies, in the period after this series of forecasts was virtually completed (i. e., after 1940), were as follows (the figures were furnished by the Commission in response to the request of this committee):

(Page 69)

Earnings on the stock (ordered by the Commission to be wiped out), Jan. 1, 1941 to June 30, 1945

* * * * *

St. Louis-San Francisco.....$36,321,158

Source: ICC table VI-C-1.

These are only the amounts of the recorded income. The actual income was much larger. All but a small percentage of the cost of the wartime installations, though deducted (for tax purposes) as an expense, was in fact a capital addition to the property. The figures showing the total for the nine systems listed abve have not yet been compiled and published; a rough estimate would assign 15 percent of the total figure for the industry to those companies (they operated about that percentage of the raiload mileage; they paid that percentage of the industry's excess-profits taxes for 1944). On the basis of a total expenditure of the industry for such installations in the amount of 1½ billion dollars, the unreported earnings on the stock of the nine systems listed above, with respect to the single item of amortization, would be approximately $225,000,000.

The actual income on the stock of those companies for the years since the Commission's no-earnings forecasts must also take account of two other items—the refund of 10 percent of excess profits paid and any additions or betterments charged as operating expenses.

It is perhaps not far from the mark to figure that the actual *earnings on the stocks of the nine systems since*

the Commission made its forecasts of no earnings on the stocks are about $750,000,000.

These figures indicate that the valuations made some years ago *require revision, even if reorganizations are still to be based on valuations, and valuations on forecasts.* When three-quarters of a billion dollars are added to the assets, which prior to such addition, had been appraised at a specified amount, that amount must be increased accordingly. *Further, the very basis of the appraisal requires modification, since it was based on a forecast of no earnings on the stock, and business operations each year thereafter showed actual earnings on the stock.*

On the question of changes subsequent to the Commission's making of an appraisal of value, the chairman of this committee said at the hearings on S. 1253:

> The Chairman. It seems to me that, when conditions have changed to such an extent as I have indicated, that railroad should have and does have the inherent right to have those changed conditions recognized (hearings, p. 76).

However, doubt has been expressed whether the Interstate Commerce Commission has the authority under the statute to recall a plan of reorganization from the courts, after it has been certified to them by the Commission. *Doubt has been expressed whether the Commission may even make representations to the district court to*

which a reorganization plan has been sent, stating that changed conditions require modification of the plan in the interest of justice. The Commission has resolved these doubts against the exercise of such power by it, and, deeming its authority strictly limited in this respect, has not made necessary revisions of plans, no matter how imperatively required in the interest of justice, unless and until the district courts have themselves found the plans to be

unfair or unsound or have for any other reason returned them to the Commission.

Such limitations obviously result in large difficulties and injustices.

District and appellate courts should not be burdened with proceedings to consider the fairness and soundness of reorganization plans *which the administrative commission may already know to be out of date.* Furthermore, a plan which is already out of date may nevertheless *pass the scrutiny of the courts because of deference for the views of the administrative tribunal and out of ignorance of the fact that members or staff of the Commission realize that the plan pending in the courts is outmoded, and that its effectuation would constitute a disregard of important facts and of important considerations of justice.* This is apparently what happened in one railroad reorganization which was consummated in 1944, and another in 1945, with serious injustice to security holders who were wiped out and with unjust enrichment of other security holders; in each case a great increase in value of the securities had taken place between the time of the Commission's first conclusion as to capitalization in reorganization, and the time the district court finally approved that conclusion and put into effect; *these changes had demonstrated that the holders of the securities wiped out under the plans actually had a genuine and valuable interest in the railroad properties and were entitled to participate in the reorganizations; since this fact, ascertainable subsequent to the Commission's decision, was disregarded, security holders were unjustly subjected to forfeiture.*

If, however, the Commission should be called upon to revise its forecasts, it would be confronted by the same difficulties as before.

Prudence calls for recognition of the wisdom of Commissioner Miller's statement in one of the cases in which the Commission was discharging the duty imposed on it by Congress, the duty of making forecasts. The Commis-

sioner said: "We are not omniscient and cannot foresee the future" (*Chicago, Rock Island & Pacific Ry. Co. Reorganization,* 242 ICC 298 at 475).

The difficulty experienced by both the Commission and others who have either been obliged or have ventured to forecast for the long future, and the hazardous nature of pessimistic forecasts in particular, are present today in as full measure as before.

Any agency, governmental or nongovernmental, obliged to make an estimate of future earnings, must answer many questions which it is difficult to answer and on which, no matter how earnest and informed the person or agency may be, error cannot be eliminated. For example, to what extent has the higher earning rate of the years 1940-45 affected the estimate which should be made for the years thereafter? What will be the effect of the carry-back provisions of the present tax law? To what extent will future earnings be benefited, by reason of recent surplus maintenance, or by reason of current and recent underrecordings of earnings? What dollars estimate shall be placed on postwar consumer demands? What will be the effect of the

(Page 71)

elimination of excess-profits taxes? What will be the effect of the initial reduction just made in income-tax rates, and what is the likelihood of future reductions?

Above all, what will be the future level of business of the railroad industry? This is perhaps the most important question of all.

It is only natural that *forecasting should partake of the mood of the period in which it is undertaken. This is true, even in the case of the most expert and disinterested forecasting.* For example, it is interesting to compare the pessimistic forecasts made at the end of the last decade with the Commission's statement to Congress early in the same decade. In 1931, when the business depression had run for only 2 years, the Commission stated:

> * * * while the tide may be slow in turning, there is no more reason for thinking that business will not improve than there was in 1928 for thinking that depressions were a thing of the past and that the country had entered an era of permanent prosperity. Too much weight ought not to be attached, therefore, to the present discouragement of investors. When railroad earnings take a sharp turn upward, as in due time they will, railroad credit will also rise (annual report for 1931, p. 115).

Reference has already been made to the statement in the 1932 report of the Commission on the basis of which it would appear that the railroads could make as large a net income as in 1929 if their future volume of business should be as much as one-half of the volume for the year 1944.

An additional question confronting individuals or agencies which make estimates of the future earnings of railroads is discussed in the concurring opinion of United States Circuit Judge Phillips in *The Denver & Rio Grande Western R. R. Co. et al. v. Insurance Group Committee et al.*, on May 10, 1945, and in testimony received at hearings on H. R. 4779, on December 26, 1945. The opinion of the presiding judge, and the testimony on the bill, both raise the question of effect on railroad revenues of a high national income in the years ahead. As Commissioner Mahaffie wrote to the House Judiciary subcommittee on December 18, 1945, such a national income "undoubtedly has some relation to railroad revenues as a whole," though it cannot be conclusive with respect to the affairs of individual roads, other facts requiring consideration also. Judge Phillips called attention to the effect of a greatly increased postwar railroad traffic on the fortunes of the road with whose reorganization under section 77 the court of appeals was then dealing.

This new factor, together with other new factors which have come to the front in the last 4 or 5 years, after the Commission initially fixed its presently outstanding pro-

posals of capitalization, add even greater emphasis to the pronouncement of the Interstate Commerce Commission in its annual report to Congress in 1938. The Commission said:

> Every reasonable effort should be made to protect existing security holders, but not where their securities have clearly lost all value (p. 21).

It is obviously difficult to reach the conclusion that junior securities of the railroads have clearly lost all value.

To wipe them out is in effect to say, at a time when these stocks are earning as much as the strongest railroads earned in the most prosperous years, these stocks must be wiped out because a Government agency, having

(Page 72)

made the most intelligent guess it could, has guessed that they may not be able to earn anything at any time in the future.

(Page 73)

EFFECT OF COURT ADMINISTRATION ON THE FINANCIAL POSITION OF RAILROADS UNDER SECTION 77

An additional difficulty arises out of the fact that for many policy purposes, court-appointed trustees have replaced the managements of companies which are in section 77 proceedings. In important respects the trustees and the courts decide, by their action or inaction, the extent of the earning power of those companies and their stocks. In particular, the courts and the trustees they appointed decide whether to cut and how much to cut, the interest charges for which the companies are obligated; *the managements of the companies are deprived of this crucial power.* The subject calls for mention of the provision of section 77 making mandatory the substitution of trustees for managements.

Section 77 was amended in 1935. One of the amendments required Federal courts to appoint trustees of the

railroad properties of companies under section 77. The purpose of this provision was to have independent investigation and correction of any abuses prior to the court proceeding (H. Rep. No. 1283, 74th Cong., 1st sess., p. 4). Such investigations have long since been completed. But the statutory provision has continued. It has ousted the managements of the roads up to the present time. *In the last few years, and now, active and aggressive management was and is critically needed in order to enable the roads to make the fullest use of present-day opportunities to reform their financial structures, reduce their indebted-*

(Page 74)

ness, and reduce the interest rates of their bonds and their total interest charges. The Interstate Commerce Commission has for some years been urging the railroads to take such action. Railroads not under section 77 have done so; railroads under section 77 have done so to a very limited extent, *and their managements have been unable to move at all in securing the very results which the Commission has wisely and repeatedly urged.*

A third difficulty is due to the fact that the sights of the courts and trustees, as well as of some of the *bondholder groups not injured by the wiping out of the stock, were directed to reorganizations having such consequences. Eyes were closed to the abundant opportunities of correcting the financial structures on a business basis, without such drastic consequences. Business conditions made possible the accomplishment, by mild procedures, of the major objective of drastic reorganizations under section 77—the reduction of interest charges. Business conditions also made possible the accomplishment, by resort to business methods, of the secondary objective of drastic 77 reorganizations—the reduction of outstanding capitalization. But section 77, the control of the properties by trustees, and the concentration on drastic reorganizations to the exclusion of solutions made available by business developments have all stood in the way.*

On the subject of business conditions which have laid the foundation for a reduction of interest charges, the Commission has frequently spoken and advised action by the railroads. It will be sufficient to quote briefly from four recent decisions by the Commission, calling attention to the developments in the money market. It noted, on July 6, 1945, "the favorable market conditions now existing" (*L. & N. R. R. Co. Bonds,* F. D. 14959). It authorized refundings at reduced interest rates because the railroads thereby effected "a saving in interest by taking advantage of the present low interest rates" (*Arkansas & Memphis Bridge & Terminal Co. Bonds,* F. D. 14918, decided July 30, 1945). It repeated its references to "present favorable market conditions" (e. g., *Union Pacific Railroad Co. Bonds,* F. D. 15035, October 5, 1945; *Lehigh & New England Railroad Co. Bonds,* F. D. 15071, October 31, 1945).

A perusal of recent decisions of the Commission shows that a large number of railroads have taken advantage of those conditions to reduce interest rates and thus total interest charges. The reduction in total charges is, of course, due in part to lowered interest rates, and in part to reductions of debt. The Commission frequently calls attention to the substantial results achieved, in a business way, by taking advantage of present conditions. For example, in one of the cases noted above, the Commission described the success of one large road in reducing its annual interest charges, over a period of years, by 46 percent (*L. & N. Bonds,* F. D. 14959). Examples were discussed at the hearings on S. 1253; Great Northern, partly through retirement of debt and partly through reduction in interest rates, cut its interest charges more than one-half (hearings on S. 1253, p. 9).

Of course, the more powerful and strongest roads have been availing themselves of the opportunity at hand; by refunding operations they have reduced the interest they pay on substantial portions of their debt, *the reduction being in a number of cases as large as 1 percent or 1½*

percent, and in some instances being even large, one case late in 1945 showing a reduction of more than 2½ percent.

(Page 75)

Rates have been reduced to 3 percent and even less (e. g., G. N. Ry. Bonds, F. D. 15014, September 11, 1945; *No. Pac. Ry. Bonds,* F. D. 15028, September 19, 1945; *So. Pac. R. Bonds,* F. D. 15020, September 19, 1945; *T. & P. Ry. Bonds,* F. D. 14958, July 19, 1945; *Un. Pac. Bonds,* F. D. 15035, October 5, 1945; *Penn, Ohio & Detroit R. Bonds,* F. D. 15063, October 17, 1945; *Western Maryland Ry.,* F. D. 15080, October 24, 1945; *Terminal R. R. Association of St. Louis,* F. D. 15070, October 26, 1945; *N. Y. Connecting R.,* F. D. 15078, October 26, 1945; *Lehigh & N. Eng. R. R.,* F. D. 15071, October 31, 1945; *Maine Central R. R.,* F. D. 15127, December 14, 1945; *C. B. & Q.,* F. D. 15125, December 19, 1945).

Other companies, of small size and not to be classified in the group which can command the lowest rates in the money market, have been making comparable progress. For example, one small road was able to refund notes at a 2½-percent interest rate (*Wichita Falls & Southern R. R. Co. Notes,* F. D. 14954, July 11, 1945). Denver Union Stock Yards Co. refunded 3¾-percent obligations and issued an additional amount all at 3 percent, the entire transaction being effected with one of the large life-insurance companies (F. D. 15055, October 5, 1945). Texas City Terminal Railway refunded an obligation which carried 4-percent interest charges, with a 10-year installment note carrying interest charges of 2⅞ percent (F. D. 15135, December 18, 1945).

Railroads which were in difficulties in the 1930's but escaped section 77 have already made great strides in the direction of reorganizing their financial affairs in this major respect. For example, the Missouri-Kansas-Texas Railroad Co., one of the companies which, though in straits during the depression, avoided section 77 proceedings, has been able to benefit by the changed conditions of the money market. *This company has just effected a 2-year bank loan*

at 1¾-percent interest, with the approval of the ICC, and is going to use the borrowed funds to retire debt on which it had been paying much higher interest rates (*Missouri-Kansas-Texas Ry. Co. Bonds*, F. D. 9660, decided by ICC December 27, 1945).

Nickel Plate, according to Mr. Purcell, vice president and general counsel of Chesapeake & Ohio Railway, was able to cut the debt and interest charges, since it was not under section 77 procedure. He said:

> The Nickel Plate, having escaped bankruptcy, was able to devote its funds to retirement of its indebtedness, and just as soon as earnings permitted, the Nickel Plate having somewhere in the neighborhood of 145 million of bonded indebtedness outstanding, set about to retire that indebtedness. And when it had brought the debt down to about $100 million through the application of excess earnings for the purpose, it was able to refinance its high interest obligations, and today it has two series of refunding mortgages outstanding, one carrying 3¾ percent and the other 3¼ percent (hearings on S. 1253, p. 81).

Similarly, the Interstate Commerce Commission noted in a recent report that Alleghany Corp., a holding company, had made excellent use of the opportunities afforded by money conditions of recent times. First, it reduced the interest rate on its indebtedness from 5 percent to 3¼ percent; early in 1945 it arranged a large bank loan for a period of a number of years at an interest rate of 2½ percent. Each borrowing at progressively lower rates, was used to retire obligations incurred at higher rates of interest (*Chesapeake & Ohio Railway Company Purchase*, 261 I. C. C. 239, 247).

Even trustees appointed by the courts to control railroads in section 77 proceedings have participated in re-

funding arrangements which reduced the interest rates

paid by raidroads. This was done, not for the companies in their control in section 77 proceedings, but for companies controlled by those railroads. Thus, one company owned by the Missouri Pacific, the St. Louis Southwestern and the Rock Island, reduced its interest rate on a bond issue from 5 percent to 2¾ percent, in a refunding operation; in the application to the Interstate Commerce Commission to authorize this refunding, the court-appointed trustees of the three railroads which jointly own the refunding company took part; the Commission was informed that this refunding was undertaken "in order to effect a saving in interest by taking advantage of the present low interest rates" (*Arkansas & Memphis Railway Bridge & Terminal Company Bonds,* F. D. 14918, July 30, 1945).

In another recent case, a large bond issue (over $40,000,000) was refunded, reducing the interest coupon from 4 percent for the bulk of it, and from 3⅜ percent for the remainder, to 2⅞ percent. The company which effected the refunding is owned by 15 railroads, including 5 which are in control of court-appointed trustees in section 77 proceedings—Missouri Pacific, St. Louis Southwestern, Rock Island, St. Louis-San Francisco, and Alton. The 15 proprietary railroads, 10 through their managements and 5 through court-appointed trustees, participated in the application to the Commission, and guaranteed the new bonds; each guaranteed one-sixteenth of the bond issue, except the trustees of the Missouri Pacific, who in its behalf guaranteed two-sixteenths (*Terminal Railroad Association of St. Louis Bonds,* F. D. 15070, Oct. 26, 1945).

In another case, a railroad company owned by the New Haven Railroad and the Pennsylvania Railroad refunded a bond issue of more than $25,000,000, reducing the interest coupon from 3½ percent to 2⅞ percent; the trustees of the New Haven, appointed by the court in section 77 proceedings, joined the Pennsylvania management in the case, and both guaranteed the new bond issue (*N. Y. Connecting Railroad Company Bonds,* F. D. 15078, Oct. 26, 1945). In another recent case, the reduction in interest

rates was effected, without a guaranty by the three proprietary roads, one of them the Missouri Pacific, controlled by court-appointed trustees (*Texas City Terminal Railway Notes*, F. D. 15135, Dec. 18, 1945).

With the significant exception of one group of railroads, the railroad industry has been making greater and greater use of the opportunity at hand in recent years. By September 30, 1942, the interest rate on over $1,000,000,000 of railroad debt had been cut more than 1 percent (Annual Report of I. C. C., p. 27). The progress since then has been large. New bonds issued in refunding operations at reduced rates of interest are likely to be the subject of further refundings at still lower rates of interest; bonds issued in such operations during the latter part of 1945 are already being prepared for further refunding, and the files of the Commission now contain official notice that this program is getting under way.

Every railroad which was in a position to do so has been benefited by the improved money market conditions. As the Interstate Commerce Commission reported to Congress in 1943, railroads are alive to the opportunity "to reduce the burden of fixed charges"; the opportunity to refund bond issues "at lower rates of interest" has already been taken advantage of by—

(Page 77)

> most railroads in a position to do. It is gratifying to report that more and more railroads in a position to do so are voluntarily reducing * * * the burden of fixed interest charges (annual report for 1945, p. 25).

Which railroads are in a position to make use of this opportunity, and to give this gratification to all who are interested in the health of the railroad industry? The managements of those companies which had the good fortune to be free from heavy maturities in initial years or for other reasons were able to avoid the section 77 procedure have reduced their interest rates. Many companies which

were under section 77 equally possess every facility for making use of this boon—except that the section 77 proceedings tied their hands. These latter railroads have big cash surpluses, they are big earners of profits, they operate in an era in which other earners have reduced their interest rates to as low as 3 percent or less. As the chairman of this committee stated at the hearings on S. 1253, *companies in section 77 proceedings have been prevented from getting "equality with other railroads" which have cut their interest rates* (hearings, p. 9). They could have worked out their own reorganizations with their creditors if their managements had been free to manage their properties and their financial affairs. *Instead, however, some of their creditors have enjoyed substantial windfalls by reason of the inability of the managements to proceed with aggressiveness and dispatch in reorganizing their financial affairs on a business basis, by business methods, and without resort to the assistance or initial participation of Government agencies. These creditors have been able to receive much higher interest rates than have been justified by money conditions of recent years and the present time.*

It is not alone while railroad properties have been in the control of the trustees under section 77 that the managements of such companies have been unable to make use of present-day money conditions. Even when the reorganization machinery of section 77 is used and companies are reorganized under that procedure, new bonds are created in the reorganization process, *and there is an opportunity to fix the interest rates of the new bonds at levels appropriate under present-day money conditions, this is not done.* Earlier in this report reference was made to the case of one railroad (the Chicago & North Western) in which some $54,000,000 of reorganization bonds were issued at an interest rate of 4 percent when 3 percent would have been far more appropriate. The result was that after the reorganization was completed, the management of the company had to go into the market and sustain the considerable expense, which was wholly unnecessary, of refunding at a 3-percent rate (ICC table III).

So far as some of the creditors are concerned, the windfall they have been receiving at the expense of the companies that are under section 77 and at the expense of their stockholders is not deemed the only factor worthy of consideration on their part. The representative of the savings bank and security owners stated in the hearings on S. 1253:

> * * * It seems to me it is better for us to take what the property can produce temporarily, over a period, than to go through this drastic reorganization procedure provided by section 77 (p. 71).

Companies in section 77 proceedings have been at a disadvantage in reducing their debt, as well as their interest rates. Major companies in section 77 proceedings have, and for several years have had, abundant funds for

(Page 78)

retiring debt. The Commission has urged all railroads to use their excess funds for such purposes. *The Commission has indicated that one method is by purchasing of outstanding bonds, on the bond market, at prices often below and even far below par, with large savings to the railroad companies* (ICC Annual Report to Congress for 1943, p. 29). *This opportunity was especially useful for companies in need of reorganization, since their bonds were particularly depressed in price.*

Striking proof of the value of the method urged by the Interstate Commerce Commission is to be found in the data it furnished at the request of this committee. *Three important railroads which achieved reorganization under the mild procedure of the Chandler and McLaughlin Acts have had marked success in buying their own bonds prior to maturity, at substantial discounts.*

(Page 79)

Our committee asked for similar data with respect to a number of roads in section 77 and equity-receivership procedure. For each of the following 11 roads, the Com-

mission's answer under the heading "Amount of bonds purchased" was "None."

These roads were in a position to save far more than were the roads which went through the chapter XV procedure, and the roads which did not go into court or Commission reorganization at all. The bonds of the companies which were under section 77 or in equity receivership were selling at far lower prices than the bonds of the other companies; and, in addition, the bonds of the former carried a number of matured, unpaid interest coupons which would be included in the price paid; for example, a company not undergoing court reorganization would buy for $485, as did the Baltimore & Ohio, simply a $1,000 bond, without any unpaid, matured coupons attached to it. But a road in section 77 proceedings would buy, for the purchase price, not only the $1,000 bond, but also a number of attached matured, unpaid coupons, which might amount to $250 or $500 more. Thus the saving for the roads in section 77 proceedings and in equity receiverships would be greater than in the case of the other roads, both because the market price was lower and because the purchase included matured, unpaid interest coupons.

In some instances the courts have ordered the use of surplus cash of railroad companies in their control to pay off entire bond issues, or to make part payment of bond issues, at 100 cents on the dollar. *The trustees did not use the surplus cash of the railroads to buy those bonds in the market at less than 100 cents on the dollar, or to call for tenders by bondholders. The result was that purchasers of the bonds at less than 100 cents on the dollar, at a time when the excess funds of the railroad companies enabled the trustees themselves to make such purchases at less than par, were able to turn in their bonds to the trustees shortly afterward at 100 cents on the dollar.* Several examples will serve to illustrate how the roads lost money in this way.

In October 1942 the trustees of St. Louis-San Francisco Railway Co. petitioned the court which had appointed them, to authorize them to pay in full, at 100 cents on the dollar, mortgage bond issues on one of the divisions of this road (the Kansas City, Memphis & Birmingham Railroad Co. general and income bonds). The court gave the authority to pay about $6,500,000 of these bonds, and they were paid in November 1942 (ICC table VI-C-4 (1). Previously, in *1941, the bonds were the subject of trading on the Boston Stock Exchange at prices ranging, for the general bonds, from a low of 80 to a high of 87½, and for the income bonds, from a low of 74 to a high of 85. In 1942, to July 1, the prices were a low of 83 and a high of 88 for the gen-*

(Page 80)

eral bonds and a low of 18½ to a high of 85 for the income bonds (Moody's Railroad Manual for 1942). *Purchasers who acquired these bonds in 1941 and 1942, when the railroad had sufficient money to enable the trustees to buy for it at those prices on the Boston Stock Exchange and in the bond market outside that exchange, were able in November 1942 to collect 100 cents on the dollar from the trustees. Neither the company nor its management had the power or liberty to use the funds of this railroad to buy the bonds on the market, and apparently the trustees appointed by the court did not think they were in a position to take such action.*

(Page 82)

VI-C-5). For each of the years 1941 to 1945, inclusive, data are presented with respect to bond issues of highest mortgage rank now outstanding in the amount of $10,000,000 or over, and listed on the New York Stock Exchange; figures were compiled showing the total of trading on that exchange in each of the issues for each year, and the high and low prices of each year (undeposited bonds and certifi-

cates of deposit for bonds are combined as one). Including over-the-counter sales, the volume was, of course, far greater than the figures here given.

(Page 83)

* * * * *

ST. LOUIS-SAN FRANCISCO Kansas City, Fort Scott & Memphis refunding 4-per-cent bonds of 1936

	Excess-cash at end of year	Face or par amount sold on New York Stock Exchange	High price	Low price
1941	$10,959,727	$5,251,000	49¼	32
1942	12,952,445	9,717,000	69¼	37½
1943	13,897,429	10,193,000	91	61
1944	15,454,650	5,291,000	90¾	71⅞
1945	.....	5,412,000	93½	78

The prices at which purchasers bid up these bonds in 1945, and the volume of purchases at such prices, indicate that the opportunity is no longer available to the companies to purchase these bonds on the market or by call for tenders, with savings of the size available heretofore. It is evident that investors now regard these bonds as prime investments; there can be little or no doubt that bonds of this rank could be floated by the companies in the ordinary financial channels. These facts constitute a tribute to the soundness of the companies; ordinarily, as experts in this financial field testified in the hearings on S. 1253, *the credit of companies in section 77 proceedings is impaired, and the prices of their bonds are considerably below their true value* (pp. 70, 116).

Though the earlier opportunity to purchase bonds of topmost rank at the large discounts obtainable in prior years has now been lost, the companies in section 77 proceedings can still reduce debt and effect substantial savings in so doing. Their second mortgage and similar bonds are still selling at less than par, even though the interest charges on these categories of bonds have been earned for a number of years—as already noted, the interest charges were earned two or more times per year, by many of the major companies, for the past 5 years.

Investors will undoubtedly continue to purchase these bonds in large quantities, and at substantial discounts from their par or face amount; this is demonstrated by figures we here cite. *The question which remains is whether the companies will be permitted to avail themselves of this opportunity, or will be deprived, as heretofore, of the right to reduce their indebtedness and to correct their financial position, by this method.*

(Page 85)

• • • • • St. Louis-San Francisco	Face amount of bonds outstanding	Face amount of bonds sold on New York Stock Exchange	High price	Low price
(1) Prior-lien 4-percent and 5-percent bonds of 1950..	$117,448,597			
1941		$26,625,000	16½	8⅝
1942		45,882,000	25⅛	10⅞
1943		69,804,000	41½	18⅝
1944		64,585,000	54	32¾
1945		61,489,000	71½	48
(2) Consolidated 4½-percent bonds of 1978	108,305,000			
1941		33,328,000	16⅜	9½
1942		46,426,000	23¼	11½
1943		72,809,000	39⅜	19⅜
1944		58,237,000	40¼	28¼
1945		55,936,000	51⅛	36¼

Rarely, if ever, in the history of the railroad industry has there been so valuable a conjunction of circumstances—low prices for buying in a company's bonds and large amounts of cash available for such purchases. Rarely, if ever, has so invaluable an opportunity been lost, as it has been lost, year after year, to the disadvantage of railroad companies, helpless in *the section 77 strait-jacket which had been devised for other times and other needs.*

The trustees in control of their affairs have not, of course, had the same incentive as their managements and owners to use the opportunity so constantly at hand. While the trustees have listened to the views of interested security

holders, they have given a greater degree of deference to the spokesmen *for bond interests than to the spokesmen for the companies and thus of the industry.*

The same may be said of a comparable method of reducing debt by the expenditure of smaller amounts than the principal and accrued interest of bonds outstanding—a public call for tenders. This can be done during chapter XV proceedings and would be available during S. 1253 proceedings; it is also available to companies which, like the Nickel Plate, proceeded without assistance of statutory aids.

Another method of reducing debt, that of paying principal and all unpaid coupons, is available under all the procedures, statutory and nonstatutory. It has been used by court-appointed trustees in the section 77 proceedings; as noted earlier in this report, the use has been a hesitant and unduly limited one, with the consequent piling up, for years, of additional interest charges on bonds which could have been, but have not been, retired. This unnecessary burden on the companies and thus on the railroad industry was criticized at the hearings on S. 1253 (pp. 9, 13, 75, 103-104).

(Page 86)

The third obstacle earlier mentioned, the assumption that companies in section 77 proceedings cannot correct their affairs, in whole or in part, by using their cash prudently to reduce debt and cut interest rates, should of course be removed.

In the long run, it will be helpful if the finances of these companies can be restored promptly under mild procedure, in accordance with business methods, and on the basis of present-day money conditions and of the cash surpluses of the companies.

In order to enable the companies to proceed with the utmost dispatch in reducing their interest charges and their

outstanding debt, it is necessary to unshackle their managements.

(Page 87)

CHANGES APPROPRIATE IN ADMINISTRATION OF RAILROADS IN HANDS OF COURTS

(1) One of the most important changes which should be made is the discharge from trusteeship or receivership of those companies which are able to pay their overdue interest, without court reorganization of their financial structures. To this end the courts and their trustees and receivers should bend their efforts, as would a company not in the hands of the courts. The advantage would be one both for bondholders and stockholders. Bondholders who are now being offered reorganization securities and are being asked to agree to substantial changes in their contractual right to receive income on their bonds currently are entitled to retain those rights, with the exception of the change in the rate of interest which money conditions and the money market necessitate.

(Page 88)

(5) The administration of reorganization can range from the drastic to the mild. *It can be geared to changed conditions —and the changes in the affairs of companies still in the hands of the courts today present a very different reorganization problem from that in the 1930's.* In consequence, the very approach made to that problem in the years prior to the vast changes in the affairs of the companies during this decade *is today outmoded. The companies themselves, by playing a larger and indeed the leading role, can bring about just results for both creditors and stockholders.* For solving their financial problems, the companies possess opportunities they did not have until the last 5 years and today have in greater abundance than at any time in the abundant 1940's.

The opportunity to bring about reductions in interest rates is something new in their affairs; *it is a substitute for*

drastic reorganization. The possession of large funds to reduce debt, and thus to eliminate interest charges on the debt retired, and to provide the basis for still further reduction of the interest rates on the balance of the debt, is of course of inestimable importance. The reduction in debt and interest charges, the record of high earnings, the easing of financial difficulties, the conversion of what seemed in the 1930's to be a mountainous task into one that is now relatively simple of adjustment between creditors and stockholders—all these indicate *the desirability of substituting a business approach for the governmental approach, and the methods of business adjustment for the methods of forecasting.* This practical method, in place of the speculative approach, will result in basic financial reorganizations of large magnitude.

Just as at the time of the enactment of section 77, so when the pattern of reorganization method and reorganization plan was set in the 1930's by Government agencies and security holders, present-day money market conditions, interest rates, and cash positions of the companies had not been foreseen. These basic changes require basic changes in the part Government plays in the recasting of the finances of the companies, as well as changes in the spirit and viewpoint of *Government authorities when they deal with this subject.*

Above all, means can and should be devised to *bridge the chasm between Commission and courts.* The latter, together with the court-appointed trustees, can, as has been noted, *advance or defeat the use by the companies of their present unparalleled opportunities to solve their remaining financial difficulties.* At the same time, in a separate compartment, the Commission is forced to operate on reorganization matters, *virtually in a vacuum;* so long as the courts and the trustees *slow up and virtually defeat the reorganization which any competent management in possession of its own properties could effect, the Commission is put in a position where, if it has to prepare re-*

organization plans it is dealing with a situation which disregards present-day realities. The courts and their trustees, on the other hand, take the view *that reorganization is not to be initiated by them, but by the Commission—although nothing in the statue forbids court or trustee action to alleviate and improve the financial affairs of the railroads, even to the point of enabling solvent railroads to secure discharge from court without any need for the Commission's operation of the reorganization machinery created by section 77.*

(Page 89)

The court-appointed trustees are under the obligation to conduct the business affairs of the roads in such manner as to yield the largest income consistent with adequate provision of transportation service to the public. In the course of so doing, the cash resources may become sufficient to enable a company to pay its unpaid interest obligations and to be discharged from court, without any reorganization at all, and thus without effectuating any plan prepared by the Commission under the provisions of section 77.

Similarly, the trustees should so order the affairs of these roads that they may be reorganized on a business basis, as fully as if the managements had been in control of their properties, without the custody of any court or trustee. Even if this did not result in wholly solving the problem of matured unpaid interest, it should be solved in part, as fully as possible. The remaining task for the Commission then becomes a relatively minor and mild one.

In dealing with such matters, the trustees need the advice of the interested security holders. Their viewpoints and their interests diverge. *The bondholders should receive payment of overdue interest, with appropriate reductions to conform to money-market conditions;* insofar as payment is not presently made in full, protection for payment of the balance should be provided—this is the accepted

and practiced method for solving such problems, as is shown by the experience in the major cases under the Chandler and McLaughlin Acts. *Section 77 is broad enough for the purpose.*

The adoption, in the respects mentioned, of a changed attitude and a changed approach *will give the bondholders their due. But it will put a stop to the forfeiture of the stockholders' rights and will prevent the transfer of their property rights without compensation to some of the bondholders, additional to the principal and interest which constitute the sole rights the bondholders can claim.*

These railroad companies whose properties are still in the hands of the courts and which cannot presently pay all past interest, and the security holders of such companies, *should endeavor to pursue the same methods, to bring about the same results, which have been successful in cases not under section 77—methods not requiring the assumption of a difficult burden which may be doomed to failure, the burden of estimating the future earnings of the railroad companies and more specifically the burden of estimating those earnings in definite number of dollars.* In consequence, it would seem desirable that the caution which various groups of security holders as well as the Interstate Commerce Commission have at times felt to be necessary should be exercised once again in this field; *that the security holders and the governmental agencies involved should once more stop, look, and observe the new developments* in the finances and the affairs of the railroad industry and these railroad companies.

(Page 94)

The original enactment of section 77, the enactment of the 1935 amendment, and the development of reorganization procedures thereunder were effected at a time when present-day money market conditions, interest rates and cash positions of the companies had not been foreseen. *Now that it is realized that procedures developed under quite*

different conditions and for other purposes, in the administration of a statute enacted when conditions were wholly different from those of today, actually serve to defeat the very purpose Congress and the railroad interests had in mind, it is essential that changes be made to meet the needs and the opportunities of the railroads at the present time.

APPENDIX C

UNITED STATES CIRCUIT COURT OF APPEALS

Eighth Circuit

Nos. 13,105; 13,106; 13,107 St. Louis-San Francisco Railway Matter, Appeals from the District Court of the U. S. for the Eastern District of Missouri.

Before GARDNER, THOMAS and RIDDICK, Circuit Judges.

GARDNER, Circuit Judge, delivered the opinion of the Court.

There are here three appeals, Nos. 13,105, 13,106 and 13,107, all from an order of the District Court approving a plan or reorganization for the St. Louis-San Francisco Railway Company. As these appeals raise substantially the same questions and were consolidated for purpose of presentation, they will be considered together. The plan of reorganization reduced the capitalization of the Railway Company from about $480,000,000.00 to about $247,000,000.00 The capitalization as so reduced is less than the secured bonded indebtedness of the Railway Company by over $110,000,000.00. The plan provides for the issuance of new securities to go to the holders of the bonds. The allocation and apportionment of these securities consisting of first mortgage bonds, second mortgage bonds and stock, among the secured creditors is not here material because all the holders of the old bonds have accepted the new plan. The old bonds were all secured by various mortgage liens on the property of the Railway Company. Under the plan there is nothing apportioned to the unsecured creditors nor to the stockholders.

The appellants are the Railway Company, representing its stockholders and unsecured creditors, and Lola Brooks, Administratrix, and John E. Dikis, Administrator, who are the owners of claims allowed in the proceedings in the bankruptcy court based upon judgments against the

Railway Company on account of damages for personal injuries and death resulting from the negligence of the Railway Company prior to the period of receivership and reorganization proceedings.

The debtor's predecessor in interest was incorporated in 1876 and went into reorganization in 1896. It was again reorganized in 1916 at which time the debtor was organized to take over the properties. The capital structure of the debtor was a matter of adverse criticism by the Interstate Commerce Commission as early as 1923. By 1932 its credit became exhausted, its taxes became delinquent and its financial stability precarious. On its application for a Reconstruction Finance Corporation loan in 1932, the Commission held that it was over-capitalized, and as a condition to authorization of a Reconstruction Finance Corporation loan the Commission required the debtor to agree to submit a plan for reduction of fixed charges. Such a plan was proposed but did not become effective and receivers were appointed November 1, 1932. On May 16, 1933, the debtor filed its petition under Section 77 of the Bankruptcy Act. The 1932 plan was ultimately held inadequate to meet debtor's needs and thereafter a new plan was proposed by three bondholders' committees. This plan, after wide investigation and careful consideration by the Commission, was submitted to the Court for its approval and it is from the order entered November 16, 1944, approving that plan that these appeals are prosecuted.

The substantial objection to the plan is that the new capitalization is too low and that it should have been fixed at an amount high enough to have satisfied all secured claims and leave some equity to be allocated to the stockholders and unsecured creditors.

In the original brief filed on hebalf of the Railway Company, its stockholders and unsecured creditors, the questions at issue are stated substantially as follows: (1) The Interstate Commerce Commission proceeeded on the assumption that the rights and interests of the unsecured creditors and the debtor in debtor's assets were and are

without value, such an assumption or finding being unfair, inequitable, arbitrary and without support in the evidence; (2) that the burden of debt of the debtor as found or assumed by the Commission was determined by the trial court without correction and without any allocation of the proceeds derived from the operation of the property during reorganization, and such burden is grossly more than warranted by the evidence or the applicable law; (3) that if the earnings during reorganization period be properly applied and the debtor's earning power properly considered, there is no reasonable basis for a finding that claims of unsecured creditors and the interest of the debtor are without value.

In support of these contentions it is argued (1) that it was beyond the power of the Commission to fix the total new capitalization at an amount less than the total claims of bondholders, and (2) that the total claims of the bondholders must be computed without regard to the interest that has accumulated on their principal during the long course of reorganization proceedings. In considering these issues we must have in mind the province of the court as distinguished from the province of the Interstate Commerce Commission, as that question has been determined by controlling decisions.

Ordinarily, the underlying necessity for the reorganization of a railroad company is that it can not support its existing capitalization. Under the equity practice there was no authority vested in the court to change or recapitalize an overburdened railroad company, nor to pare down secured debts without a sale of the security. With the adoption of Section 77 of the Bankruptcy Act, however, the Interstate Commerce Commission was given the initial power of determining the new capitalization of a reorganized railroad. The Act made it possible to eliminate the foreclosure and sale under mortgages against the railway property, and conferred upon the reorganization court the power to determine the value of conflicting claims. The Act also conferred upon the Interstate Commerce Commis-

sion the duty and power of determining the new capitalization. In the determination of this important question it is necessary to ascertain the prospective earning power of the Railway Company considered as a going concern. While jurisdiction of the property of the Railway Company and its management, maintenance and operation during the process of reorganization is vested in the court, certain matters were left to the determination of the Interstate Commerce Commission, and its determination of those questions if sustained by substantial evidence and not violative of legal standards, is conclusive on the courts. *Ecker, et al. v. Western Pacific R. Corp.*, 318 U. S. 448; *Group of Investors v. Chicago, M. St. P. & P. R. Co.*, 318 U. S. 523.

Manifestly, if the value of the new securities does not exceed the amount of the secured claims, then neither the unsecured claims nor the stockholders can benefit by any change in the apportionment of the new securities. The general creditors and stockholders are confessedly junior in all resepcts to the claims of the bondholders. *Louisville Trust Co. v. Louisville, N. A. & C. R. Co.*, 174 U. S. 674; *Northern Pac. Ry. Co. v. Boyd*, 228 U. S. 482; *Case et al., v. Los Angeles Lumber Products Co.*, 308 U. S. 106. In the final analysis, the controlling if not the only question presented by these appeals is whether the action of the Commission in determining the capitalization of the Railway Company as represented by the new securities, approved by the tral court, should be set aside in order to bring about some allocation of the new securities to the general creditors and stockholders.

The Supreme Court, in *Ecker v. Western Pacific R. Corp., supra*, and *Group of Investors v. Chicago, M. St. P. & P. R. Co., supra*, has indicated the relative functions to be performed by the Commission and the reorganizing court. In the Eckert case it is said:

> "These reorganizations require something more than contests between adversary interests to produce plans which are fair and in the public interest.

When the public interest, as distinguished from private, bulks large in the problem, the solution is largely a function of the legislative and administrative agencies of government with their facilities and experience in investigating all aspects of the problem and apprasing the general interest. Congress outlined the course reorganization is to follow. It established standards for administration and placed in the hands of the Commission the primary responsibility for the development of a suitable plan. When examined to learn the purpose of its enactment, Section 77 manifests the intention of Congress to place reorganization under the leadership of the Commission, subject to a degree of participation by the court.

"It is clear from the discussions and the statute itself that there was recognition by everyone of the advantages of utilizing the facilities of the Commission for investigation into the many-sided problems of transportaton service, finance and public interest involved in even minor railroad reorganizations and utilizing the Commission's experience in these fields for the appraisals of values and the development of a plan or reorganization, fair to the public, creditors and stockholders. The resulting legislation was an attempted balance between the power of the Commission and that of the court."

Again the court said:

"The power of the court does not extend to participation in all responsibilities of the Commission. Valuation is a function limited to the Commission, without the necessity of approval by the court. * * *

"The function of valuation thus left to the Commission is the determination of the worth of the property valued, whether stated in dollars, in securities or otherwise. One of the primary objects of the bill was the elimination of obstructive litigation on the issue of valuation to that position as seemed to the drafts-

men legally possible. Judicial reexamination was not considered desirable. None of the findings required of the judge under subsection (e) relate specifically to valuation. Congress apparently intended to leave the determination of valuation 'of any property for any purpose under this section' to the Commission."

Again it is said:

"Another restriction on court action is that the determination as to whether the plan is 'compatible with the public interest' rests, as valuation does, with the Commission. * * *

"* * * Capitalization is an essential factor bearing on an efficient transportation system for shipper, investor and consumer. The development of the capitalization of the reorganized company which is entrusted solely to the Commission under the requirement that the plan be compatible with the public interest is that relating to the total amount of issuable securities and the quality of the securities to be issued. *So long as legal standards are followed, the judgment of the Commission on such capitalization is final.*" (Italics supplied)

Again the court said:

"Assuming at this point that the Commission's valuation is sound and reached by allowable methods, a matter discussed later in this opinion at page 477, we hold that the elimination of the claims of stockholders and creditors which are valueless from participation in the reorganization is in accordance with valid provisions of Section 77 (e)."

In *Massachusetts Mutual Lfe Ins. Co. v. Securities & Exchange Commission,* 151 F. 2d 424, we said:

"Since there is a 'rational basis' in fact for the finding of the Commission and no 'clear-cut' error of law by either Commission or court, we are not inclined to disturb the conclusion * * *."

To the same effect see: *Archer v. Securities & Exchange Commission,* 8 Cir., 133 F. 2d 795; *Board of Trade v. United States,* 314 U. S. 534.

It is clear that the Commission has the power to limit total capitalization and its finding on the question of reorganization value is not subject to review. It is urged, however, that the Commission arbitrarily assume a value, and complaint is made that the Commission did not, in words at least, find or fix the value of the property involved. In view of the very extensive investigation by the Commission of every element or factor having any conceivable bearing on the question of future earning capacity, including the condition and nature of the physical properties, the past earnings record and all circumstances which bear upon the question of future earnings or value, it can not reasonably be said that the Commission assume anything.

The Supreme Court, in *Group of Investors v. Milwaukee R. Co., supra,* speaking of the work of the Commission as reflected by the record in that case, said:

> "It reviewed freight and total revenues, passenger revenues and their trend, operating revenues and expenses, and maintenance and efficiency of operation for various periods ending in 1938. It gave consideration to estimated future taxes, emergency freight charges, and certain wage factors. It reviewed the amounts of income available for payment of interest in each of the years from 1921 to 1938. It considered the original cost of the properties, the cost of reproduction now, the cost of reproduction less depreciation, and the value for rate making purposes—each of which was substantially in excess of the capitalization which it authorized."

The investigation made by the Commission in the instant case has been as searching and as thorough as that referred to in the Milwaukee case. Here, as in the Milwaukee and Western Pacific cases, the Commission based its de-

termination as to the capitalization largely upon the earning capacity of the railroad, and in the Milwaukee case the court said:

> "Certainly there is no constitutional reason why earning power may not be utilized as the criterion for determining value for reorganization purposes."

For reorganization purposes the value depends upon its earning capacity. " * * * the commercial value of property consists in the expectation of income from it * * *." *Galveston, H. & S. A. R. Co. v. Texas,* 210 U. S. 217. As said by the Supreme Court in *Consolidated Rock Product Co. v. DuBois,* 312 U. S. 510,

> "The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various elements is to be fair and equitable."

These authorities dispose of appellants' contention that the original cost of reproduction should govern reorganization value. The determination by the Commission of the aggregate amount of securities that may be issued is in effect a finding of total value for reorganization purposes. The Commission, as has already been observed, had before it and considered every element or factor affecting value, including the evidence as to the original cost of reproduction of the physical properties. It held extended hearings at various times between July, 1933, and February, 1944, and a perusal of the record makes apposite what is said by the court below:

> "The extent of the record on these questions is appalling and it is difficult for the court to understand how anyone could contend that the Commission has omitted to go into every phase of the debtor's existence."

The trial court, in referring to the work and findings of the Commission, further said:

"The Commission has * * * gone exhaustively into the history of the debtor corporation, including the development of its physical and financial structure and that of its subsidiaries; into the characteristics of its properties and their condition and improvements; into the traffic experience, year by year, by commodities and revenue tons carried, and by flow of traffic over various parts of the system, and by the prospect for the future; into operating revenues for each year since 1915 by classes and compared by ratios to the total in the preceding year; into expenses and operating ratios since 1915, both maintenance and improvement, and into taxation; into the net earnings available for interest since the debtor has been in existence; and elaborately into the elements of physical value."

In the appeals of Brooks and Dikis, the same contentions are urged as in the appeal of the debtor, but they make some further contentions with reference to the Commission's findings. It is said that the Commission overlooked certain unmortgaged assets, namely, the cash on hand at the time of the receivership, November 1, 1932, and the cash thereafter collected by the receivers before the order segregating income for the benefit of bondholders, and it is urged that they should share in the cash assets on a parity with bondholders. As compared with the claims of bondholders, their claims are so small that their share would be negligible, if indeed not infinitesimal. The Commission found that the mortgage liens covered the entire system and that the greater part of the cash at least was subject to the lien of the various mortgages. Each of the mortgages covers all income. The trustees under the mortgages made proper demand for the income, and the court, by an order entered March 10, 1933, appointing receivers, directed the trustees to hold the mortgaged property, including the rents, issues and profits thereof. The bankruptcy court thereafter confirmed and adopted this order. The lien of the mortgages related back to the inception of the proceedings and was entitled to preference over the

competing claims of general creditors. In *Mortgage Loan Co. v. Livingston,* 45 F. 2d 28, we said:

> "So here, the receiver, while not appointed in a separate suit instituted by the mortgages, was functioning on behalf of all creditors with due regard to priorities of claims and liens on the property of the bankrupt."

See, also: *In re Wakey,* 7 Cir., 50 F. 2d 869; Central *Hanover Bank & Tr. Co. v. Philadelphia & Reading Coal & Iron Co.,* 3 Cir., 99 F. 2d 642.

Any equitable interest which Brooks and Dikis may assert in the mortgaged property is subject to the payment of the bonds, as the existence of a junior lien does not unsettle the rights of the senior claimants. *Louisville Tr. Co. v. Louisville, N. A. & C. R. Co., supra; Case et al v. Los Angeles Lumber Products Co., supra.*

It is also urged by Brooks and Dikis that they were in fact not general creditors, but entitled to some preferential treatment. True, they may have liens in the states in which their judgments were entered but these liens are subject to pre-existing liens and certainly junior to the lien of the bondholders. It is also urged that they were entitled to priority of payment under the equity rule allowing priority to those who furnish material for the operation of a railroad within a limited time before receivership. Proceedings to determine that question seem to be pending and we do not believe a plan of reorganization should embody an adjudication or classification of individual claims, and we express no opinion on the question.

Again, it is urged that there are current assets of the value of $50,000,000.00 which should be available to pay debts. From the current assets on hand the court ordered payment of the 1945 interest, and manifestly, the Railway Company as a going concern can not, even for the purpose of paying creditors, be left stranded for want of operating funds. These so-called funds on hand belonged to the Railway Company and while they may tend to enhance some-

what the value of the new stock and bonds, these stocks and bonds are held by those who have preferred claims and if the funds could be taken from the company for the purpose of paying debts they should be applied upon the remaining unsatisfied preferred claims of the bondholders, so that no possible benefit could inure to the stockholders or unsecured creditors. The finding of the Commission as to the amount due on the preferred claims is challenged and it is argued that the bondholders were not entitled to interest from the time of the initiation of the reorganization proceedings. The argument, however, overlooks the fact that the property in reorganization was all subject to the mortgage liens and these mortgages cover not only the payment of the principal but also the payment of interest. Interest on secured claims to the effective date of the plan is entitled to the same priority as the principal. *Consolidated Rock Products Co. v. DuBois, supra; Ecker v. Western Pacific R. Corp., supra; Case v. Los Angeles Lumber Products Co., supra; Louisville Joint Stock Land Bank v. Radford,* 295 U. S. 555; *American Iron & Steel Mfg. Co. v. Seaboard Air Line Railway,* 233 U. S. 261; *Group of Investors v. Milwaukee R. Co., supra.* The time as of which the claims of creditors should be computed was fixed as January 1, 1944. From that time the interest on the securities will be the new rate, but up to that time it will be computed on the old securities at the contract rate. This determination, we think, is reasonable and equitable and violative of no legal principle.

In a reply brief filed by the debtor subsequent to oral argument on leave of court, it is suggested that the decision of this case be held until it is determined whether there will be an order of confirmation brought to this court on appeal, and that such an appeal should be considered before we decide the issues in the present appeal. We can see no justification for further delay. We need not here anticipate what questions for review might be presented on such an appeal further than to observe that Section 77 provides that when a plan is approved by the Commsision and

the District Court, it shall then be submitted to the security holders whose interests are of value and are affected by the plan, and after vote by them it shall come again to the District Court to be confirmed. If the plan is accepted by more than two-thirds of those voting in each class to which submission is required, then the District Court, we think, will not again consider the merits of the plan. If the plan has been accepted and the acceptance has been properly obtained it will then be confirmed. In the instant case, the plan has already been accepted by more than two-thirds of those voting in each class to which the submission was required. Certainly, in those circumstances there should be no further delay in this proceeding which has already been pending for more than twelve years.

As the order appealed form is sustained by substantial evidence and the Commission in reaching its determination has applied proper standards as declared by controlling decisions of the Supreme Court, it is affirmed.

APPENDIX D

Remarks of Judge Evans of the Seventh Circuit in Rock Island Reorganization, No. 8930.

JUDGE EVANS: One point which gives me some anxiety is that in the Supreme Court it was said valuation was a matter of income, in the St. Paul case didn't think that the question of valuation was to be determined by an appraisal of the property, but by the income.

MR. BROWN: Yes, your Honor.

JUDGE EVANS: That income has changed so radically from the time that valuation was first fixed that it is hard to assume that the valuation was correct.

MR. BROWN: Yes, that is perfectly true. But, in the Milwaukee decision there was some war earnings. But, no one contends that the Rock Island earnings of the last three or four years are going to be earnings on which a permanent plan should be based.

JUDGE EVANS: That might be, but it did show, apparently, and lots of people have rather indicated that they believe that increased or swollen income will be, in part, carried on through because of what has taken place in railroad management, in equipment, and so forth, during the last ten years; in other words, valuation based upon income. While railroad income during the war would be greater than in peace, probably, that income will be larger than the amount upon which the original valuation was based.

MR. BROWN: I don't think there is anything in the record in this case, I am sure there is nothing in the record in this case, hearing this appeal on its full merits and full record upon which this Court could determine whether the Rock Island earnings for the next three years, or the next one year, can be expected to continue. The record that will come to your Honors on this full appeal will be only historical earnings.

JUDGE EVANS: We may be bound by judicial prece-

dent, which is quite strong in your favor, in the St. Paul case. But, where they tried to get in was when the plan went back from the District Court to the Commission and the Commission says only the questions that caused the Court not to approve, only those questions will be considered—in other words, then was the time, probably, if the Interstate Commerce Commission was desirous of doing complete justice and ascertaining, or checking on itself: Did we make the correct finding of the value of this railroad?—when to our great surprise and to the great surprise of everybody else, something happened, to wit, war, and the revenues just doubled. If you start with a value that is going to be determined on the basis of revenues and something happens that causes revenues to double, then it comes back—"Well, how about it?" And: "No, we won't go back of it, we will stick by what we said." Is that entirely right?

MR. BROWN: If we follow that line of thought, it is impossible for me to say, or understand how the Rock Island can be reorganized within less than ten years from now.

JUDGE EVANS: Maybe so, but there is also the thought that if it takes ten years to get it right it is pretty nearly right to do it.

I had quite a little part in the St. Paul Railroad, and it was always shocking to think that there should be such an absolute denial of any right for any stockholder, notwithstanding that money was just rolling into the St. Paul and the North Western Railroad, but notwithstanding that, it was decided, "You are out." That don't set very well on your conscience. If you did it wrong, it is about time you correct it.

Of course, we don't want any longer reorganization of this railroad than is necessary. But, there was quite a big difference between the first one and the last one, attributable to a difference in revenue, due to, we will say, primarily to war, but not entirely. There has been a tre-

mendous change in operation and management, and so forth, of railroads. No man can ride on a railroad and not see it and not have it outlined to him. It is not alone the convenience and the amount of tons of freight hauled by one engine, but the cost per mile of hauling is startling. It has all taken place, it seems to me, in the last ten or fifteen years. It is truly remarkable it had to be a period of depression, and almost a loss of all railroads, that they should wake up and go after the business as they should have done long before, instead of merely figuring on refinancing that has been the mistake of the railroads.

MR. BROWN: I am in full agreement with the last portion of your remarks. My difficulty comes from my belief that this Court was right when it indicated that Section 77 did not contemplate an indefinite nursing receivership. I don't believe it contemplates a holding of the railroad under the umbrella of the chancellor while we see whether the next ten years will continue the remarkable war earnings, or whether we will see something other than that. You cannot predict future earnings on the earnings of the Rock Island in the last few years.

JUDGE EVANS: If I remember correctly, Justice Sutherland wrote the opinion in the Rock Island case, and we both commented on the delay in these reorganizations, and we thought about two years ought to be long enough to reorganize, and it has been twelve years, and we haven't got it yet.

MR. BROWN: I think the parties thought so, too.

JUDGE EVANS: I also realize that in ten years I have never seen such a change in railroad operation and railroad revenue: I never had my confidence in my judgment of valuation so shaken as it was when the returns began to come in from railroad operation during the war period, when previously common and preferred stocks were wiped out with a sweep of the hand, and in the next year they made enough so that that stock that was wiped out could have received 10 cents on the dollar and still have something left in the treasury.